Understanding China

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Standards for Enterprise Management Control

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Preface

With continuous academic efforts in the theory and methods of enterprise management control, a growing number of organizations are applying such principles in their operations. We publish this book, *Standards for Enterprise Management Control*, in order to facilitate the proliferation of management control for commercial practitioners. This English edition is distributed globally to accommodate international audiences with interests in management control as it applies to Chinese enterprises and cross-border organizations.

Standards for Enterprise Management Control is organized in four parts:

- **Part I** provides the necessary background and framework for a discussion on enterprise management control standards. It addresses a number of topics around the subject such as its history, purpose, practical value, and structure.
- **Part II** introduces a basic standard for enterprise management control. This part consists of seven sections including general provisions, elements, contents, procedures, modes, monitoring and assessment, and supplementary provisions.
- **Part III** introduces application guidelines for enterprise management control standards. This consists of application guidelines around regulation control system, budget control system, evaluation control system, and incentive control system.
- **Part IV** provides case studies on the application of enterprise management control standards. It discusses the subject from the perspective of four enterprises each with a unique approach to management control.

Standards for Enterprise Management Control is the companion volume of *Enterprise Management Control System in China* by the same author. This English edition allows international scholars and practitioners to better understand the evolution of management control standards after China's economic reform. Furthermore, this book aims to promote further international academic collaboration on the theoretical research and practical application of enterprise management control.

Dalian, China Xianzhi Zhang

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10/26/2014, Dalian Prof. Dr. Xianzhi Zhang

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Chapter 1
Value and Integral Design of Standards for Enterprise Management Control

1.1 The Background of Formulating the *Standards for Enterprise Management Control*

With economic globalization going further, enterprise risk issues are increasing. Many countries in the world emphasize on enterprise internal control, and a series of regulations and standards are being formulated and implemented by organizations, such as the famous COSO frameworks. In China, enterprise internal control and risk management are also attached great importance and *Standards for Enterprise Internal Control* has been established. Generally, management control is the process by which managers influence other members of the organization to implement the organization's strategies (Anthony and Govindarajan 1998). Management control is linked closely with internal control. They are interrelated a lot, but not the same. The emergence and development of the management control is determined by the demand and supply of management control theory and practice. The demand and supply of management control should be matched. All these provide a background of formulating a system of *Standards for Enterprise Management Control*, especially in China.

1.1.1 The Formulation and Development of COSO Frameworks

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) was organized in October 1985. It was sponsored jointly by five major professional associations headquartered in the United States.[1] The COSO's mission is to provide

[1] the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors

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thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence, which are designed to improve organizational performance and governance and to reduce the extent of fraud in organizations (COSO website: http://www.coso.org/aboutus.htm).

Regarding internal control, in September 1992, the four volume report entitled *Internal Control—Integrated Framework* was released by COSO and later republished with minor amendments in July 1994. This report presented a common definition of internal control and provided a framework against which internal control systems may be assessed and improved. This report is one kind of standard that U.S. companies use to evaluate their compliance. According to a poll by CFO magazine released in 2006, 82 % of respondents were claimed to use COSO's framework for internal controls (CFO website: http://ww2.cfo.com/accounting-tax/2006/03/the-trouble-with-coso/). In order to increase the relevance of *Internal Control—Integrated Framework* in rapidly changing and complex global business environment the COSO revised the framework in May 2013.

The COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of specified objectives, i.e., effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations, and safeguarding of assets. The COSO internal control framework consists of five interrelated components derived from the way management runs a business, i.e., control environment, risk assessment, control activities, information and communication, and monitoring. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization as required by financial regulations, and it improves the information environment for decision making and keeping risk within acceptable range.

High-profile business scandals and failures (e.g. Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom) led to calls for enhanced corporate governance and risk management. As a result the Sarbanes-Oxley Act of 2002 (SOX) was enacted. This law extends the long-standing requirement for public companies to maintain systems of internal control, requiring management to certify and the independent auditor to attest to the effectiveness of those systems. The *Internal Control—Integrated Framework* continues to serve as the broadly accepted standard for satisfying those reporting requirements; however, in September 2004 COSO published *Enterprise Risk Management—Integrated Framework*. COSO believes this framework to expand on internal control, providing a more robust and extensive focus on the broader subject of enterprise risk management.

This enterprise risk management framework is still geared to achieving an entity's objectives; however, the framework now includes four categories, including (1) Strategic: high-level goals, aligned with and supporting its mission; (2) Operations:

(IIA), and the National Association of Accountants (now the Institute of Management Accountants [IMA]).

effective and efficient use of its resources; (3) Reporting: reliability of reporting; (4) Compliance: compliance with applicable laws and regulations. Enterprise risk management consists of eight interrelated components derived from the way management runs an enterprise and are integrated with the management process. It encompasses the previous five components of the *Internal Control—Integrated Framework* while expanding the model to meet the growing demand for risk management. However, COSO admits in their report that while enterprise risk management provides important benefits, limitations exist. For example, human failures such as simple errors or mistakes can lead to inadequate responses to risk; controls can be circumvented by collusion of two or more people, and management has the ability to override enterprise risk management decisions, etc.

1.1.2 The Establishment and Implementation of Standards for Enterprise Internal Control *in China*

In China, investors and policymakers have also paid increasing attention to firms' internal controls. During the last decade, internal control systems have been established in most listed companies and some unlisted companies.

In May 2006, the China Security Regulatory Committee (CSRC) issued "Measures for the Administration of Initial Public Offering and Listing of Stocks", which requires internal controls for listed companies for the first time. According to this regulation, companies in the initial public offering (IPO) process must have a sound and effective internal control system that should guarantee the reliability of financial reports, compliance with laws and regulations, efficiency and effectiveness of business operations (Tong et al. 2014). In the same year, Shanghai Stock Exchange and Shenzhen Stock Exchange respectively released two similar Listed Company's Internal Control Guidelines, which require the main board listed companies[2] to establish internal control according to them. When disclosing the annual report, the board of directors should disclose the report of management's assessment of the effectiveness of internal control, and disclose accounting firm's opinions on the management's assessment report. These two early guidelines, having no legal force, just acting as the standard of guiding document, and its implementation is limited to the two main board listed company (Wang et al. 2013).

In May 2008, the Ministry of Finance, CSRC and other three commissions issued the *Basic Standard for Enterprise Internal Control*, which is considered as the Chinese SOX and is aimed at standardizing the construction of internal controls in Chinese firms and strengthening the supervision and assessment of internal controls

[2] In Shanghai Stock Exchange and Shenzhen Stock Exchange of China, the listed companies are divided into three levels, i.e., Main Board listed companies, Small and Medium Enterprise (SME) listed companies and Growth Enterprise Market (GEM) listed companies according to their size and features.

(Sun et al. 2012). It has to be carried out from July 1, 2009 within the listed companies. In April 2010, *Application Guidelines for Enterprise Internal Control*, *Guidelines for Assessment of Enterprise Internal Control* and *Guidelines for Audit of Enterprise Internal Control* (hereinafter referred to as "*Implementary Guidelines for Enterprise Internal Control*") were released, and listed companies in Shanghai and Shenzhen Stock Exchange have to comply with these two sets of regulations effective from January 1, 2012. Unlisted firms of large and median sizes are also encouraged to comply with the Guidelines. The internal control objectives and components are similar to that of COSO frameworks. It is mandatory that, when implementing the Basic Standard and the Implementary Guidelines, all listed companies or an unlisted large and medium-sized company should carry out an effective self-assessment of its internal control and issue a self-assessment report on an annual basis, and should appoint an accounting firm to audit the effectiveness of its internal control over financial reporting.

1.1.3 *The Demand for* Standards for Enterprise Management Control

Stakeholders who pay attention to the efficiency and effectiveness of enterprise operating activities have a strong demand for *Standards for Enterprise Management Control*. The stakeholders mainly include external regulators on behalf of the public interests, different parties related to corporate governance, i.e., shareholders, the board of directors, the board of supervisors and creditors, and managers and employees in different levels of the enterprise who dominate the daily operating activities.

1.1.3.1 External Supervision Demand for *Standards for Enterprise Management Control*

The Stakeholders Theory figures that "a stakeholder is any group or individual who can affect, or is affected by, the achievement of a corporation's purpose." (Edward 1984). With the increase of complexities of the business organization and business activities, the scope of enterprise stakeholders is gradually expanding. There are direct stakeholders and indirect stakeholders. Direct stakeholders include shareholders, managers, employees, creditors, customers, and suppliers, etc., while indirect stakeholders include communities, governments, social organizations, and the media, etc. Their behaviors can influence the enterprise or be objectively influenced by the enterprise. In this sense, it is necessary to strengthen external supervision in order to protect the interests of stakeholders under the environment of asymmetric information. For one thing, external supervision can supervise the behavior of managers; for another, it can also effectively prevent risks and protect the interests of stakeholders.

However, the drawbacks of planned economy have already proved that external supervision cannot, after all, be achieved by directly interfering the management activities of the enterprise. Meanwhile, it cannot be completely equal to the "externalization of internal control", which means that under incompletely constrained condition, external control alone will not work very well, such as forces from accounting firms, China Securities Regulatory Commission (CSRC) and so on. A series of cases of corporate frauds, bankruptcies, insolvencies have proved that external forces did play a role, but at the same time, there are two problems noted such as "non-independence" and "assimilation". External supervision has a very high cost and yet the results are not very satisfactory. Therefore, in order to standardize the operating and management activities, to prevent the risk, and to improve the operational efficiency and effectiveness, it is necessary to build a comprehensive and binding system of standards for enterprise management control.

And the benefit of establishing *Standards for Enterprise Management Control* is obvious. On the one hand, it will provide the regulatory bodies with a system of reference standards for supervision and evaluation. These Standards regulate the basic elements of the management control system, which include two key elements of control variables and control standards. The critical control variables provide the regulatory parties with important indicators they should focus on, while the control standards provide the quantitative basis when analyzing, evaluating and judging. On the other hand, it will also enable the regulatory parties to administrate under the principle of "there must be laws to go by, the laws must be observed and strictly enforced, and lawbreakers must be prosecuted", which will then strengthen the force of supervision. In addition, if the enterprise implements these Standards effectively, it will also act as a kind of substitute mechanism of external supervision.

1.1.3.2 Corporate Governance Demand for *Standards for Enterprise Management Control*

In a broad sense, corporate governance is the highest level of management control in an enterprise; while, in a narrow sense, corporate governance is an important factor of management control environment. The establishment and implementation of *Standards for Enterprise Management Control* will help to improve corporate governance structure.

The objective of corporate governance is to deal with issues of rights and responsibilities, control and incentive among shareholders, board of directors and the management. In different modes of management control, these mechanisms are mainly reflected in the following aspects: (1) Strategic control in the regulation (rule-based) control system, including the articles of association, the company's strategic planning, organizational structure and corporate governance system, etc.; (2) The control of strategic planning and budget objective in the budget control system; (3) The evaluation control of the management by board of directors in the evaluation control system, which includes evaluation of management activities and financial

performance, etc.; (4) The incentive control of the management by shareholders in the incentive control system, for example, stock options, salaries, bonus, etc.

All the above issues are about the consistency or compatibility of objectives between board of directors and shareholders, between senior managers and board of directors, as well as the efficiency and effectiveness of senior management and operating activities. In all, from the perspective of corporate governance, a scientific and systematic *Standards for Enterprise Management Control* is necessary.

1.1.3.3 Management Demand for *Standards for Enterprise Management Control*

The principal-agent theory is an important factor to explain the management demand for *Standards for Enterprise Management Control*.[3] Principal-agent theory suggests that one participant (the principal) hope another participant (the agent) to choose actions in accordance with their interests, however, the principal cannot directly observe the agent's behaviors but some incomplete information such as some variables (Zhang Weiying 1996). When this theory is applied to enterprise management, it means that certain objectives are set by the managers, but it cannot be directly observed whether the employees abide by the objectives or requirements. Thereby, in essence, the enterprise needs a series of contracts to motivate the employees so as to make their actions in accordance with the requirements of managers. Management control system is just the collection of such series of contracts, and its basic objective is to make management activities more effective and efficient. The so-called effectiveness can be interpreted from the perspective of whether managers' actions are consistent with organizational goals or the degree of consistency with the goals. Taking the effectiveness of management activities as a fundamental objective of establishing management control system will improve the degree of consistency between staff actions and organizational goals, and thus reduce the problem of asymmetric information under principal-agent relationship.

Meanwhile, the current state of enterprise management in China suggests that management control abounds with failure examples. Although many enterprises have established formal internal control systems in accordance with the requirements of related regulations, the majority are remained just focusing on the guarantee of accounting information truth and reliability. As a matter of fact, accounting activities only represents one kind of management activities. Hence, strengthening accounting controls alone does not mean a sound internal control system, facts also prove that within enterprises, irregularities are still emerging in an endless stream and inefficiencies are still common. Therefore, it is necessary to provide a standardized framework for management control systems, and to establish a mechanism which is able to control management activities and form an organic system for enterprise operation. A set of practical and operable *Standards for Enterprise*

[3] Since corporate governance demand for *Standards for Enterprise Management Control* has been elaborated above, it is not discussed here. The principal-agent relation here only refers to the relation between enterprises' senior managers and their subordinate managers and employees.

Management Control may precisely cater to the urgent needs of internal management of the enterprises.

1.1.4 The Supply of Standards for Enterprise Management Control

Above analysis shows a strong demand for *Standards for Enterprise Management Control* from both inside and outside of the enterprises. Similarly, from the perspective of supply of *Standards for Enterprise Management Control*, the condition has already been relatively mature from either the aspect of theoretical basis of management control, or the aspect of macro-environment of the establishment and implementation of the standards, or the aspect of micro-foundation of the operation of the standards. It is completely possible to establish and implement *Standards for Enterprise Management Control* at present.

1.1.4.1 The Development of the Theoretical and Methodology System of Management Control

In the early 1900s, international theoretical circles started research in the field of management control. The first textbook which directly related to management control, "*Industry Control*", was completed in 1920 by Francis M. Rosen (Giovanni and Bedeian 1974). Therefore, it has been more than 90 years since management control was discussed as an independent field in theory. Currently, the theoretical framework of management control in the USA has been mature enough to the point that "the management control framework that students learned a few decades ago remains basically valid" (Anthony and Govindarajan 1998). As for management control research in Britain, there is a specialized Management Control Association which studies a series of special topics on management control and has developed many collected papers including all aspects of management control. On the basis of precedent research, Simon (1995) put forward four levels of management control, and based on them he established four basic management control systems including beliefs control system, boundary control system, diagnostic control system and interactive control system (Simons 1995). This can be regarded as a sign of maturity of western management control.

In China, there is also a long history of management control research. However, the original studies are always limited to one aspect of management control, such as budget management, performance evaluation, etc., which lacks a systematic framework for management control research. In recent years, a group of Chinese scholars, represented by Prof. Zhang Xianzhi,[4] did a lot of research directly in the field of

[4] One of his books *Enterprise Management Control Systems in China* was published by Springer in 2014.

management control theory and practice. The theoretical framework has been established and improved including the nature of management control, the elements of management control, the procedures of management control and the modes of management control, etc., which provides an integrated theoretical and methodology system for management control (Zhang Xianzhi 2004, 2014). Especially, the four kinds of management control modes, i.e., regulation control system, budget control system, evaluation control system and incentive control system, have laid a practical foundation for the establishment and implementation of *Standards for Enterprise Management Control*.

Therefore, from the perspective of the development of management control, all the theoretical and methodology foundations are completed for the birth of a set of scientific and systematic *Standards for Enterprise Management Control*.

1.1.4.2 The Macro-environment of the Establishment and Implementation of *Standards for Enterprise Management Control*

The macro-environment of management control includes a variety of factors, such as legal environment, political environment, technological environment, business environment, industrial competition environment, and supplier as well as customer environment, etc. These factors are critical to establishment and operation of enterprise management control. Of all the factors, economic institutional environment is the basic constraints of the implementation of *Standards for Enterprise Management Control*, while legal environment is the fundamental guarantee for it.

A good economic institutional environment will provide fundamental supports for the establishment and implementation of *Standards for Enterprise Management Control*. Currently, as can be seen in China, it is in a critical stage of development of market based economic system, which provides the most basic institution environment. Under previous planned economy, the enterprises took too much burden of social function, which ignores "profit-seeking" nature of the firm and loses the basic precondition of economic management. As the objectives of traditional Chinese enterprises do not focus on the profit, the objectives of management control were ignored. With the in-depth reform and development of socialist market economy, pursuing the maximum of economic benefits has become the most fundamental goal of the enterprises. Modern enterprise system provides a solid platform for the realization of organizational goals. Under the new economic system and enterprise's objectives, it has created the basic conditions for the pursuit of management control objectives. The realization of the efficiency and effectiveness of management control is possible, which contribute to the establishment and implementation of *Standards for Enterprise Management Control*.

The improvement of legal environment plays a fundamental role in safeguarding a new system or standard. As to the *Standards for Enterprise Management Control*, the four modes of management control system are the most important carriers, and no matter which mode is implemented, it is essential to find a series of laws to

safeguard. Without the limitations of the labor laws, the regulation control could easily become a kind of physical punishment to the staffs and violate human rights; without the rules of related tax laws, some option incentives in incentive control system could easily become a way of tax evasion; without criminal laws with regard to economic crimes, many managers would improve economic performance unreasonably through the behavior of bribery or bribe-taking, etc. Legal system in China has been relatively sound and it can provide fundamental legal safeguards for management control behaviors. Since the foundation of People's Republic of China, legal system in China is continuously improving, and now it has formulated a system of laws which includes constitutional laws, civil and commercial laws, administrative laws, economic laws, criminal laws, litigation and non-litigation procedural laws, etc. Especially, with the development of civil and commercial laws, as well as economic laws, market mechanisms has improved continuously and the order of business competition is increasingly transparent. Thereby all these laws provide a solid foundation for management control systems attempted to improve the efficiency and effectiveness of management activities.

1.1.4.3 The Micro-foundation of the Operation of *Standards for Enterprise Management Control*

In fact, the objectives of management control are the highest level of objectives of internal control, thus the operation of *Standards for Enterprise Management Control* should have some essential micro-foundations. These foundations should at least include the following important environmental factors: corporate governance structure, organizational structure, managerial infrastructure and enterprise culture.

From the perspective of corporate governance structure, although the control of corporate governance structure is beyond the scope of management control, a clear corporate governance framework is very important for the effectiveness of management control. In China, state-owned enterprises are experiencing an adjustment of structure of property rights, and corporate governance framework has been clear. Apart from some special enterprises in which state-owned shares dominate the majority, the other enterprises have less state-owned shares but more private shares. Therefore, the enterprises will be able to completely operate in accordance with the market-oriented pattern, which increase the possibility for the implementation of *Standards for Enterprise Management Control*.

From the perspective of organizational structure, which can be grouped into functional structure, business unit structure and shareholding structure, the foundation is built. Different kinds of organizational structure have different management control methods and authorities. The enterprise's organizational structure has a major influence on its management control methods and contents. Now, in China, there are plenty of successful cases of enterprises that applied functional structure, business unit structure or shareholding structure with a good performance. This provides a structural basis and also precedent cases for selecting different management control systems based on different organizational structures.

From the perspective of managerial infrastructure within enterprises, Chinese enterprises have already built the technical foundation and basic institutional foundation for management control. For a long time, in order to guarantee the reliability of financial reporting and to comply with related laws and regulations, a lot of enterprises have established and improved all kinds of management control methods and control system, such as segregation of duties system, authorization and approval system, budget management system, internal audit system, etc., which provides a good institutional basis for the implementation of enterprise management control system. The application of accounting information systems and electronic information technology also provides a basic technical support for management information system (MIS).

From the perspective of enterprise culture, it plays a critical role on management control system through the function guiding, unifying and motivating, etc., which helps to unify the employee's thinking and behaviors in line with the objectives of the enterprise. Currently, enterprise culture has become an increasingly important topic in China's enterprise management, which will help to achieve the objectives of *Standards for Enterprise Management Control*.

1.2 The Connotation and Status of *Standards for Enterprise Management Control*

To standardize and enhance enterprise management control, and to improve the efficiency and effectiveness of business management, *Standards for Enterprise Management Control* is essential. It is the linkage of linking management control theory and management control practice. At first, we should understand the connotation and status of it to seize its nature.

1.2.1 The Connotation of Standards for Enterprise Management Control

Standards for Enterprise Management Control is a programmatic document to regulate the operation of the management control systems. It is the most fundamental and essential code of conduct to direct enterprises and other economic organizations, as well as non-profit organizations such as state organs, social groups and public institutions to conduct management control.

Standards for Enterprise Management Control contains the basic standard and application guidelines. Basic standard for management control is the "basic rules" or the "mother law", which is a kind of summarization or generalization of management control theories, including the general principles, elements, contents procedures, modes, monitoring and assessment of management control, etc. Application

guidelines for management control are the "specific rules" or the "son laws", which are developed according to the framework of management control system modes, and they respectively regulate the operation of management control activities and guide companies to choose and implement different modes of control according to their own specific environment.

The first step of developing *Standards for Enterprise Management Control* is to formulate the basic standards for management control, so as to form the overall framework for enterprise management control, which is the foundation of developing specific application guidelines of management control. Under the guidance of the basic standard, the application guidelines of management control should be developed in accordance with the principles of importance, feasibility and operability, etc.

1.2.2 Standards for Enterprise Management Control *and Current System of Laws and Regulations*

In terms of the content, China's current financial and economic laws system includes laws such as; the company laws, accounting laws, audit laws, tax laws, securities laws as well as other laws and relevant regulations. *Standards for Enterprise Management Control* is not one formally part of China's current system of laws and regulations but an important supplement for them.

According to the hierarchy of laws and regulations, there are five levels, such as follows: the first level is the laws enacted by the National People's Congress and its Standing Committee, such as *Company Law*, *Accounting Law*, *Tax Law*, etc.; the second level is the laws and regulations enacted or promulgated by the State Council, such as *Assessment of State-owned Assets Management Approach* and *Corporate Financial and Accounting Reports Ordinance*, etc.; the third level is the laws and regulations jointly enacted and promulgated by the Ministry of Finance and other ministries, such as *Accounting Standard for Business Enterprises, Accounting System for Business Enterprises* and *Standards for Enterprise Internal Control*, etc.; the fourth level is the laws and regulations enacted by local governments, ministries and non-governmental organizations (NGOs), such as *Shanghai Securities and Exchange Management Approach* issued by Shanghai Municipal People's Government, and *Interim Measures on Securities Issuance and Listing Sponsor System* issued by the China Securities Regulatory Commission (CSRC); the fifth level is the systems, norms or articles developed by enterprises, non-profit organization and administrative units. The above five levels of laws and regulations have the characteristics that the upper levels govern the lower levels, and the lower levels are more specific and operable. Over viewing the above five levels of laws and regulations, it can be found that although the *Standards for Enterprise Internal Control* is enacted, it only emphasizes on accounting controls and financial controls and ignores management controls, especially it lacks the evaluation control and incentive

control mechanisms. Therefore, the establishment of *Standards for Enterprise Management Control* is essential, and it should be located on the fifth level of current system of laws and regulations due to its nature and function.

According to the role of regulations, they can be divided into enterprise's external regulations and internal regulations. External regulations can be regarded as the yardsticks of external governmental or institutional supervision, while internal regulations can be used as the rules of companies, governments and non-profit organizations to conduct internal operations. At present, Chinese laws and regulations are mainly focus on the external regulations and neglect internal management regulations. Therefore, *Standards for Enterprise Management Control* can be regarded as a kind of enterprise's internal regulations, which is not mandatory but necessary.

1.2.3 The Status of Standards for Enterprise Management Control

Standards for Enterprise Management Control is mainly designed to regulate the management behaviors of the enterprises and other organizations, but it is not the mandatory requirement from external supervision departments. Management control, as a kind of means to implement strategy, can be used to help managers to realize the objectives of the organizations. Hence, the primary purpose of *Standards for Enterprise Management Control* is to provide guidelines for enterprise managers so that they can establish normative management control system and, finally, achieve enterprise's final objectives.

What is the relationship between *Standards for Enterprise Management Control* and the existing of *Standards for Enterprise Internal Control*? In our opinion, *Standards for Enterprise Management Control* is a kind of useful supplement to *Basic Standard for Enterprise Internal Control*, and these two sets of standards altogether constitute a complete system of enterprise internal control. In terms of the guiding ideology, *Standards for Enterprise Management Control* and *Standards for Enterprise Internal Control* are the same. To be more specific, both are established on the background of Chinese enterprises' current situation and designed to strengthen enterprises' internal control. They all provide regulations and references for the enterprises so that they can achieve standardization and institutionalization of management in practice, however, they have different responsibilities and function in different aspects.

The objectives and principles of management control and internal control are consistent, but there are some differences in the specific procedures and methods. *Standards for Enterprise Internal Control* is highly concerning on the risk and develops a series of procedures and methods to identify risk, assess risk, deal with risk and report risk. *Standards for Enterprise Management Control* also emphasizes on the risk, at the same time, it provides more operable procedures and more specific management control modes. Besides, *Standards for Enterprise Management*

Control is also characterized by the diversity of methods. The control methods ruled by *Standard for Enterprise Internal Control* mainly includes incompatible duties control, accounting system control, budget control, property preservation control, internal reporting control and electronic information technology control, etc. These basic control methods are also included in *Standards for Enterprise Management Control*; meanwhile, it also lays emphasis on behavior control, evaluation control, incentive control and other comprehensive control methods to stimulate the initiative and creativity of the managers and employees.

1.3 The Value of the Establishment of *Standards for Enterprise Management Control*

As mentioned above, the conditions of demand and supply for the establishment of *Standards for Enterprise Management Control* are ripe. Such a set of standards are not only necessary but also entirely possible. The value of establishing the *Standards for Enterprise Management Control* is mainly reflected in two aspects of the theoretical value and practical value.

1.3.1 Theoretical Value of the Establishment of Standards for Enterprise Management Control

Standards for Enterprise Management Control not only accounts for one important part of management control theories, but also acts as one kind of supplements to the existing laws and regulations. It will formulate a strong force to promote the study and development of both the theories and the regulations.

1.3.1.1 Constituting One Important Part of Management Control Theories

"Theory is a kind of systematic expression to the rules and principles of specified series of phenomena, which can be regarded as a helpful framework for understanding related concepts, explaining related phenomena and predicting related behaviors" (Most 1977). According to this definition, the "understanding related concepts" mainly refers to the basic theoretical issues, while the "explaining related phenomena and predicting related behaviors" refers to applied theoretical issues. Therefore, strictly speaking, a complete theoretical system should at least include two parts of basic theory and applied theory. So the management control theories should also consist of the basic theory and applied theory.

As mentioned above, the basic theoretical research on management control in China has begun to take shape, and some theoretical frameworks have been built. However, the research on applied theory is rare in each management control theoretical system. As an important part of the theoretical system of management control, the introduction of *Standards for Enterprise Management Control* will improve the management control theories, especially about the applied theory. Meanwhile, with a logical and complete management control framework embodied in a specific standard, it will raise the public awareness of management control. Thereby this theory can be continuously tested, refined and sublimated in practice, which has great significance for the growth and development of China's theoretical research on management control. In addition, it will also help to supplement some other related field in theory, such as internal control, management accounting, corporate finance, corporate governance, internal audit, etc.

1.3.1.2 Acting as an Supplement to the Existing Laws and Regulations

Currently, there are no independent laws or regulations of management control. What can be perceived about management control is scattered in various related laws, rules, institutions and regulations. This violates the integrity of the whole management control system. The establishment of *Standards for Enterprise Management Control* will play an important role of supplementing current laws and regulations and building a systematic framework for management control.

Early in April 1988, the *Law of Industrial Enterprises under Ownership by the Whole People of People's Republic of China* was issued, which ruled "socialist production should improve business management, strengthen responsibility system and increase economic efficiency". This was the first time to emphasize management control in the level of law. With the release of new *Company Law*, *Securities Law*, *Accounting Law* and *Audit Law*, etc., a series of regulations and standards were also issued. In January 2001 and December 2002, the Ministry of Finance of China issued the trial *Basic Standard for Internal Accounting Control Standards* and a series of specific guidelines to regulate accounting issues. As mentioned above, in May 2006, the China Security Regulatory Committee (CSRC) issued *Measures for the Administration of Initial Public Offering and Listing of Stocks*, which requires mandatory internal controls for listed companies' IPO; Both the Shanghai Stock Exchange and Shenzhen Stock Exchange issued two *Listed Companies Internal Control Guidelines* in 2006, which require all listed companies on the two main board to establish internal control according to them; in May 2008, the Ministry of Finance and other four commissions issued the *Basic Standard for Enterprise Internal Control*, which is considered as the Chinese SOX; in April 2010, *Implementary Guidelines for Enterprise Internal Control* were released to ensure the implementation of enterprise internal control. Besides, there are also a lot of other regulations related to enterprise management control, such as regulations of budget management, performance evaluation, stock option incentives, etc.

Without exception, these regulations or standards emphasized the importance for an enterprise to establish an effective internal control system, and some parts of them even directly focus on management control. However, there are still no independent standards or reference for enterprise management control at present. There are no specific guidelines either to norm management control behaviors such as regulation control, budget control, evaluation control and incentive control. Therefore, the introduction of *Standards for Enterprise Management Control* will bridge this gap and act as an important supplement to the existing laws and regulations related to management control.

1.3.2 *Practical Value of the Establishment of* Standards for Enterprise Management Control

Standards for Enterprise Management Control will not only help to improve enterprise operation and management behaviors, but will also help to promote the healthy operation and development of macro-economy. It will also play an important role of governance of modern enterprise and the society.

1.3.2.1 Improving Enterprise Operation and Management Behaviors

Standards for Enterprise Management Control will help to improve enterprises' internal control mechanism and to form a sound internal control system. According to the four objectives of internal control, i.e., the reliability of corporate strategy, effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations, and safeguarding of assets, the majority of Chinese enterprises' internal control stays in the level of financial reporting control. But many enterprises were much concerning on standardizing accounting process and improving the quality of accounting information. However, only accounting control is not enough, because it ignores strategy control and operational control. Management control activities involve all aspects of the management activities, and the environmental factors should also be considered such as corporate strategy, corporate governance structure, responsibility centers, human resource policies, corporate culture, etc. The significance of *Standards for Enterprise Management Control* lies in that a sound internal control system is formulated by establishing management control system with environmental adaptability.

Standards for Enterprise Management Control is a kind of practical handbook. It details the objectives of management control and implements the essence of management control with specific implementing principles. Besides, on basis of different methods, it provides different modes of management control system which can operate under different specific conditions. Under the requirement of *Standards for Enterprise Management Control*, the managers should not only focus on the

behaviors of internal check, internal audit, etc., but also pay more attention on how to improve the efficiency and effectiveness of operation and management behaviors. This requires that, it should strengthen the awareness of risk prevention, make self-diagnosis as well as self-improvement through management control to achieve strategic objectives. Therefore, *Standards for Enterprise Management Control* will help to improve the operation and management activities.

Meanwhile, because *Standards for Enterprise Management Control* stresses on the importance of management control environment, the changes of organizational strategy, organizational structure, responsibility centers, corporate culture, and human resource policies may all lead to the alteration of management control modes and methods. This requires the managers in each level to consider their management behaviors in a unified system, which can cultivate overall viewpoint and the awareness of collaboration among different departments. In addition, although *Standards for Enterprise Management Control* mainly refers to enterprises and other economic organizations, its thought and system can also be useful to the government agencies, public bodies and other non-profit organizations.

1.3.2.2 Promoting the Healthy Operation and Development of Macro-economy

In terms of macro economy, the institutionalization of management control will not only help to maintain the market order, but also is conducive to prevent the negative effects of management control failure, which will ensure the stability and healthy development of the economy. *Standards for Enterprise Management Control* enhances the status of the efficiency and effectiveness of operating in business management, which means that the managers will be mainly responsible for the failure of management control. Under this kind of responsibility, the managers must try their best to improve the efficiency and effectiveness of operation and management activities, and even the potential on-the-job consumption phenomenon will decrease. This will contribute to macroeconomic development finally with no doubts by increasing productivity. Meanwhile, the improvement of the efficiency and effectiveness of operation and management activities is also conducive to reduce some social problems, such as the problem of unemployment, economic crimes, waste of social resources, environmental pollution, etc.

The enterprises' competitiveness of one country is usually regarded as a symbol of comprehensive national strength. With the development of the economy, especially after WTO, Chinese enterprises gradually participate in the worldwide economic competition. In order to survive, the enterprises have to compete with multinational corporations who implement the global business strategy. Hence, only by enhancing enterprises' international competitiveness, can national economic power be strengthened. According to a report, released in February 2003, called "Evaluation Report of International Competitiveness of China's Large and Medium-sized Enterprises 2002–2003", the evaluation index system of international competitiveness of the enterprise include the five elements, i.e., size and efficiency,

management and practice, learning and innovation, marketing and market share, environment and impacts. In order to achieve these goals, Chinese enterprises will not only have to establish modern enterprise system and implement scientific management, but also face the challenges of improving of the efficiency and effectiveness of operating and establishing management control system adaptable to global economic competition. According to practical experience and theoretical progress of management control, the establishment of *Standards for Enterprise Management Control* has positive effects for enterprises to coordinate internal resources, to adapt the changing external environment.

1.4 The Integral Design of the Establishment of *Standards for Enterprise Management Control*

To design the *Standards for Enterprise Management Control*, it should be in accordance with related laws and regulations, with reference to *Standards for Enterprise Internal Control* and its *Implementary Guidelines*, directed by the basic theories of management control, and based on the framework of management control modes. In all, the *Standards for Enterprise Management Control* should adapt management control environment of Chinese enterprises with Chinese characteristics.

1.4.1 The Legal Basis and Reference Template of Standards for Enterprise Management Control

Company Law of People's Republic of China is the mainly legal basis for the establishment of *Standards for Enterprise Management Control*. The Article 5 of Company Law states that "a company should operate independently and assume sole responsibility for its profits or losses with its all legal property. Under the government's macro-control, the company should make productions and manage independently to improve economic benefits, labor productivity, and maintenance and appreciation of assets value." According to this regulation, improving economic benefits, labor productivity and assets appreciation are all listed as the operating objectives of the company. This is exactly the problem that *Standards for Enterprise Management Control* tries to solve, i.e., to control or prevent operation risk, to improve the effectiveness of business management, and to ensure the strategy can be implemented so that the organization's objectives can be achieved. The Article 5 of Company Law also regulates that "a company should implement a management system which has clarifying responsibilities, scientific management, and combination of incentives with constraints." This is exactly the responsibility of the establishment of *Standards for Enterprise Management Control*. Besides, the Securities Law, Accounting Law and other relevant laws and regulations also provide basis for the Standards.

Management control and accounting control are two important parts of internal control. The establishment of *Standards for Enterprise Management Control* should be coordinated with *Standards for Enterprise Internal Control* and its implementation guidelines. The *Basic Standard for Enterprise Management Control* should refer to *Basic Standard for Enterprise Internal Control*, and application guidelines should also be made with reference to the implementation guidelines of internal control. These two sets of management control standards and internal control standards are similar in some degree, but not the same thing. They should be complemented and coordinated with each other. With respect to the classification and content of the guidelines, the implementation guidelines of internal control include application guidelines, assessment guidelines and audit guidelines due to the character of compulsory internal control, whereas, the management control should focus mainly on the application guidelines because it is not mandatory. The application guidelines of internal control standard are developed according to the elements of internal control, whereas, the application guidelines of management control should be formulated on the base of management control modes. This will not only highlight the features of management control but also avoid the repetition with internal control.

1.4.2 The Modes of Management Control System in Standards for Enterprise Management Control

Management control system modes reflect the mechanisms, modalities and methods of the operation of the management control system. The classification of management control system modes should base on two points, i.e., management control environment and the features of management control in different stages. According to the theory and the evolution of management control, as a framework, management control system modes can be classified into four kinds, i.e., regulation control system, budget control system, evaluation control system and incentive control system. The control methods, objectives, advantages and obstacles of these four kinds of management control modes are different, and each has got its own characteristics. The enterprise shall choose the management control mode that is suitable to its own control environment and features, and we will take this as a foundation to develop four management control application guidelines.

From the perspective of control environment and control authorization, the four kinds of management control modes are in four different classes. Incentive control system has the highest control authorization and requirement of control environment; next is the evaluation control system; then budget control system; and regulation control system has the lowest control authorization and requirement of control environment. The four kinds of management control system modes are both independent and uniform. The independence refers to that each can operate as a standalone control system. The so-called uniformity refers to that the same enterprise can use two or more control systems simultaneously, and control enterprises from the perspective of the rules, procedures, objectives and interests respectively. For

instance, an enterprise group can mainly adopt budget management control system and supplemented by other control modes.

Control environment, which can be divided into external and internal environment, is one of the basic elements of management control systems. It should stresses on the role of control environment when the decision makers design and make choice of the suitable modes of management control system for the enterprise. After giving the definition and analysis of the external and internal environment, Zhang Xianzhi (2010) reviews the literature on the evolution of management control system modes to draw the consensus of the role of control environment in designing management control modes. The environment of enterprise management control in China is so diversified that there is no one-size-fits-all mode. According to China's current situation of control environment, most companies require regulation control system mode to implement strategies. Budget control system mode is relatively advanced and feasible control mode which is suitable for some companies, and so far, only a few companies can adopt the evaluation control system mode while fewer companies can directly adopt the incentive control systems mode.

1.4.3 The Structure and Content of Standards for Enterprise Management Control

The system of *Standards for Enterprise Management Control* is mainly composed of two parts, i.e., basic standard and application guidelines. The first part is called *Basic Standards for Enterprise Management Control*, while the second part consists of four *Application Guidelines for Enterprise Management Control* based on the four kinds of management control system modes, including AGEMC[5] No. 1—Regulation Control System, AGEMC No. 2—Budget Control System, AGEMC No. 3—Evaluation Control System, and AGEMC No. 4—Incentive Control System. The basic standard guides the specific application guidelines.

1.4.3.1 Basic Standard for Enterprise Management Control

The *Basic Standard for Enterprise Management Control* is composed of general provisions, management control elements, management control contents, management control procedures, management control modes, monitoring and assessment, and the supplementary provisions. These all together formulate a conceptual framework that guides the application guidelines and management control practice.

In the general provisions, the definition, objectives, principles and requirements, theoretical structure and practical foundations of management control are presented. Then, ten management control elements are defined including control environment,

[5] It is the abbreviation of *Application Guidelines for Enterprise Management Control*.

control variables, control standards, information reports, execution of evaluation, deviation correction, performance evaluation, incentive mechanism, communication, and monitoring; the management control environment is explained in detail in this part due to its priority and importance. In the next section, management control contents are defined according to control subjects, control objects and control processes. Then, the Standard regulates five basic management control procedures such as strategic objectives decomposition, control standards development, management control reports, operating performance evaluation and executive compensation. As a kind of innovation, management control modes are explained in the next section such as regulation control system, budget control system, evaluation control system and incentive control system. Monitoring and assessment of management control are also presented in this Standard. Lastly, the supplementary provisions state the power of this Standard.

1.4.3.2 Application Guidelines for Enterprise Management Control

(1) AGEMC No. 1—Regulation Control System

Regulation control system refers to regulating and limiting managers and employees at all levels through the form of regulations, guidelines and other norms to achieve organizational goals, and to ensure that management activities are not contrary to the realization of the organization's strategic objectives. The function of regulation control system is to make it clear about the to-do and not-to-do for managers and employees through abiding by relevant rules and regulations.

The application guidelines for regulation control system is composed of the following parts: general provisions, such as the basis, definition and applied range of regulation control system; the objectives and principles of regulation control system; the categories and contents of regulation control system, mainly including rules of strategic control, rules of management control and rules of task control; the procedures and methods of regulation control system; the environments and conditions of regulation control system.

(2) AGEMC No. 2—Budget Control System

Budget control system refers to the process of regulating the organization objectives and economic behaviors through the form of budget plan, adjusting and modifying management behavior and target deviation to ensure achievement of objectives, strategies, policies and planning of all levels. The function of budget control system is to ensure that the managers and staffs understand their quantitative objectives and be aware of the influence of their behavior biases on the objectives in time, so that they can correct the deviation timely and achieve the desired objectives.

The application guidelines for budget control system is composed of the following parts: general provisions, such as the basis, definition and applied range of budget control system; the objectives and principles of budget control system; the organizations and responsibilities of budget control system; the categories and

contents of budget control system; the procedures and methods of budget control; the environments and conditions of budget control system.

(3) AGEMC No. 3—Evaluation Control System

Evaluation control system refers to regulating the economic objectives and economic behaviors of the managers and staffs at all levels in the organization through the way of evaluation. The evaluation control emphasizes the control objectives rather than control processes. As long as the management objectives at all levels are achieved, the organizational strategic objectives will be achieved. The function of evaluation control system is to make managers at all levels understand their own objectives and the objectives of their superiors, peers or subordinates, so that their initiatives are motivated to achieve the objectives.

The application guidelines for evaluation control system is composed of the following parts: general provisions, such as, definition and applied range of evaluation control system; the objectives and principles of evaluation control system; the organizations and responsibilities of evaluation control system; the ranges and contents of evaluation control system; the procedures and methods of evaluation control system; the environments and conditions of evaluation control system.

(4) AGEMC No. 4—Incentive Control System

Incentive control refers to controlling the behavior of managers by the way of giving them motivations, so as to coordinate the behavior of managers with enterprise objectives (or the objectives of the owners). Besides regulation control system, budget control system and evaluation control system, incentive control system is also a subsystem of management control aimed to motivate the managers to create more value for the enterprise.

The application guidelines for incentive control system is composed of the following parts: general provisions, such as, definition and applied range of incentive control system; the objectives and principles of incentive control system; the categories and contents of incentive control system, including positive and negative, spirit and material incentive, etc.; the procedures and methods of incentive control system; the environments and conditions of incentive control system.

1.5 The Implementation and Application of *Standards for Enterprise Management Control*

An enterprise shall establish and implement its management control in accordance with the *Standards for Enterprise Management Control*. Other entities may take guidance from it. The key point of implementing management control is to choose the modes of management control reasonably, but it is also necessary to assess the implementations of management control so as to ensure its effectiveness.

1.5.1 *The Range of Application of* Standards for Enterprise Management Control

This Standard applies to all kinds of enterprises, such as, large, medium-sized and small-sized enterprises that were established according to the laws of the People's Republic of China. Other economic entities and non-profit organizations, such as state organs, social groups and institutions, may take guidance from this Standard when establishing and implementing their management control. Organizations from other counties may also take some guidance from this Standard.

All kinds of organizations can achieve their objectives by means of management control that is an effective tool to implement strategies. Broadly speaking, the organization is defined by systems that consist of many elements linked with each other in a certain way in order to achieve specific objectives. Under the market economy environment, doing research on management control with enterprises as its object has a more important significance.

1.5.2 *The Choice of Modes of Enterprise Management Control*

The achievement of enterprise's objectives depends on the implementation of enterprise strategy; the obstacle of implementing strategy mainly comes from operating risk; the characteristics of risk are determined by the operating environment of the enterprise. Therefore, effectiveness of management control depends on whether an enterprise can choose suitable modes of management control based on internal and external environment. In reality, the selection of modes of management control does not mean that selecting one mode from four modes. Even for one enterprise, it may choose several different modes of management control at the same time and put rational weight on each one according to specific environment. Generally, only when the regulation and budget control systems are improved and operate perfectly, then the enterprise can take evaluation and incentive control systems.

External environment is objective and exogenous for an enterprise, which includes social environment, political environment, technological environment, business environment, industry competitive environment, suppliers and customers environment, etc. but each factor have got many sub-factors. For example, social and political environment includes the factors of moral, culture, religion, ecology, etc. If the institution of the whole country and people's moral quality is relatively high, an enterprise can put higher weight on evaluation and incentive control systems to decrease transaction costs. However, in view of the fact that there exists a great deal of deficiencies in formal and informal institutions in China, an enterprises should attach enough importance to the modes of regulation and budget control, and choosing the modes of evaluation and incentive control should be prudent.

Internal environment is relatively subjective and endogenous for an enterprise, which mainly includes organizational strategy, organizational structure,

responsibility center, enterprise culture and human resource, etc. On one side, an enterprise should understand and accept its current internal environment; on the other side, the board of directors and top management should also actively build a good environment for the implementation of management control. As mentioned above, maybe the formal and informal institutional environment are not perfect in China, the enterprises should be careful to choose modes of evaluation and incentive control systems. However, after internal environment reaches due level, still paying much more attention to regulation and budget control and ignoring evaluation and incentive control would reduce initiative and creativity of staffs in an enterprise.

In other words, an enterprise should fully consider both external and internal environment to select suitable modes of management control.

1.5.3 The Assessment of the Implementation of Management Control

Different from performance evaluation of management control procedures, the assessment of the implementation of enterprise management control is essential. Understanding the connotation, principles, contents and procedures of management control assessment is important. It is the guarantee of implementing management control effectively for an enterprise.

1.5.3.1 The Connotation and Principles of Management Control Assessment

Assessment of management control refers to the process performed by an enterprise's board of directors or similar authority to comprehensively assess the effectiveness of the management control system, draw conclusion and issue assessment reports thereon. The objective of the assessment of the implementation of enterprise management control is to promote the effectiveness of management control, to regulate the procedures and reports of the assessment of management control, and to identify and prevent related risks.

The enterprise shall at least comply with the following principles in performing management control assessment: (1) Comprehensiveness, i.e., assessment shall cover management control system's design and operations, as well as each line of business and activity of the enterprise and its subsidiaries; (2) Significance i.e., assessment shall focus on key functions and units, major and important business activities and high risk areas; (3) Objectivity i.e., assessment shall be accurate and factual reflection of the enterprise's operating and management risk profile, as well as the management control system's design and operating effectiveness.

In accordance with the status of the management control system's design and operation, an enterprise shall establish detailed policies and procedures for assessing

management control; specify the assessment principles, contents, procedures, methods and reporting modes; define responsibilities and each level of authority for relevant departments/units or posts; implement a system of accountability; and perform an orderly assessment of management control in line with the stipulated methods, procedures and requirements. The board of directors shall be responsible for the truthfulness and effectiveness of the management control assessment report.

1.5.3.2 The Contents of Management Control Assessment

In accordance with the *Basic Standard for Enterprise Management Control*, the *Application Guidelines for Enterprise Management Control* and its own management control system, the enterprise shall identify the detailed contents of management control assessment and comprehensively assess the management control system's design and operation based on the modes of regulation control, budget control, evaluation control and incentive control. The key of effective implementation of management control lies in correct choice of the modes of management control. Therefore, the enterprise should assess the implementation of management control primarily from the angle of the modes of management control, meanwhile, from the angle of the elements, procedures and contents of management control.

In assessing management control, working papers shall be formed to document in detail the contents of the enterprise's assessment process, including the assessed components, major risks, adopted control measures, related evidence, and the results of verification. The working papers of assessment shall be reasonably designed, contain sufficient evidence, and be convenient to use and edit.

1.5.3.3 The Procedures of Management control Assessment

A management control assessment includes the following procedures: developing a work plan, establishing an assessment team, performing on-site testing, determining control deficiencies and preparing a report. The enterprise may authorize the internal audit function or a designated function to be responsible for organizing and performing the assessment of management control.

(1) Developing a work plan. The enterprise's management control functions shall draft a work plan to define the scope of the assessment, work assignment, staff of organization, schedules and expense budget and shall then implement the plan after the approval of the Board or its authorized agency.
(2) Establishing an assessment team. In accordance with the approved assessment work plan, the enterprise shall establish an assessment team to perform the detailed assessment of management control. The team shall comprise experienced persons from an enterprise's internal departments/units with relevant knowledge. Members of the team shall avoid conducting an assessment on his/her own department's management control. The enterprise may also appoint an intermediary organization to assess the effectiveness of management control.

(3) Performing on-site testing. The management control assessment team shall conduct testing, obtain adequate and reliable evidence on the design and operating effectiveness of the enterprise's management control through individual interviews, questionnaires, discussions, walk-through tests, on-site examinations, sampling tests etc. The team shall complete the assessment working papers and analyze management control deficiencies based on the detailed contents of the assessment.
(4) Determining control deficiencies. Management control deficiencies can be classified into design deficiencies and operating deficiencies. The determination of management control deficiencies shall be based on routine and special monitoring and shall take into account the annual management control assessment. After a comprehensive analysis, the management control function team shall submit the determination result to be reviewed in accordance with prescribed authority and procedures before final approval. The management control function team shall also prepare a summary of determined management control deficiencies.
(5) Preparing a report. The enterprise shall prepare management control assessment report timely in accordance with the specified procedures and requirements. The types, formats and contents of their management control assessment report should be designed according to organizational characteristics. The purpose of preparing report is to provide information on the implementation of management control for the board of directors and enterprise's managers who should identify, according to evaluation report, deficiencies of management control system and take measures to improve it.

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Part II
Basic Standard for Enterprise Management Control

Chapter 2
Basic Standard for Enterprise Management Control

2.1 General Provisions

Article 1 This Standard has been formulated in accordance with the Company Law, Securities Law, Accounting Law and other relevant laws and regulations of the People's Republic of China for the purpose of standardizing and enhancing enterprise management control, improving the efficiency and effectiveness of business management, promoting sustainable business development, and accelerating the development of macro economy.

Article 2 This Standard applies to all kinds of enterprises, such as large, middle and small-sized enterprises. Other economic entities and non-profit organizations, such as state organs, social groups and institutions, may also seek guidance from this Standard while establishing and implementing their management control.

Article 3 According to this Standard, the "management control" means the aggregation of the control processes carried out by the internal controllers in order to ensure the effectiveness of operating activities. Those responsible for management control are at different levels of management in the organization. The effectiveness of operating activities is subject to the organization's strategic objectives. So management control is the process by which managers influence other members of the organization to implement the organization's strategies. Specifically, the purpose of management control system is to help the management to coordinate different activities within the organization so that the organization objectives will be achieved.

Article 4 The objectives of management control are to prevent operation risk, to improve the effectiveness of business management, and to ensure the strategy can be implemented so that the organization objectives will be achieved. According to the levels of enterprise objectives, in a broad sense, the objectives of management control can be divided into strategic objectives, overall operational objectives and specific task objectives. From the perspective of risk control, the objectives of

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management control are to control strategic risk, overall operational risk and specific task risk, after the legal risk, finance and accounting risk are all controlled or prevented.

The objective of strategic effectiveness is the highest priority of management control. As a kind of long term objectives, mainly developed by board of directors, strategic objectives dominate the objectives of management control, and management control is to ensure the organization's strategies are being implemented effectively. Strategic objectives control should include the control process of strategy analysis, strategy choice, strategy implementation and strategy adjustment, etc.

The objective of overall operational effectiveness is the core objective of management control. In a narrow sense, overall operational objectives are exactly management control objectives that mainly implemented by the managers. The achievement of management control objectives is the basis of strategic objectives realization. In management control the focus is mainly on organizational units called responsibility centers to ensure the effectiveness of operations, i.e., to improve the efficiency and effectiveness of business operation. Operation efficiency is the ratio of operating incomes to operating expenses. Operation effectiveness refers to the effective result or performance of operating activities.

The objective of task effectiveness is the requirement of all kinds of task activities mainly executed by the employees. The process of management control to implement the strategy is ultimately reflected by the control of all kind of task activities. Task control is the process of ensuring that specific tasks are carried out effectively and efficiently. The focus of task control is on individual tasks or transaction, such as scheduling and controlling individual job through a shop, as contrasted with measuring the performance of the shop as a whole. If there is no achievement of specific task objectives, there will be no realization of overall operational objectives and strategic objectives.

Article 5 When establishing and implementing management control, an enterprise shall observe the following basic principles:

(1) The planning principle. It means that management control of an enterprise should reflect complete programs and accomplishment of planned targets. The planning principle is the essential requirement for management control.
(2) The suitability principle. It means that management control of an enterprise should take into account the characteristics of organizational environment and take appropriate actions according to different circumstances.
(3) The materiality principle (critical point). It means that management control of an enterprise should mainly focus on major (important) issues and may ignore minor (less important) issues which do not pose any threat to organizational objectives.
(4) The trend control principle. It means that management control of an enterprise should discover the problems and potential threats from the analysis of historical data and current status in the process of management control, and then take corrective measures to prevent them from happening again.

(5) The exception control principle. It means that an enterprise should pay attention to the control of abnormal and unconventional situations in the process of management control, which is the basic requirement to improve the control efficiency.
(6) The pre-active control principle. It means that an enterprise should take preventive control measures in advance through improving the quality of the control subject. Pre-active control principle emphasizes the training of those responsible for management control is of key importance.

Article 6 Enterprise management control shall also meet the following requirements:

(1) People orientation. People oriented control indicates that people are the most important asset of an organization. In management control practices, people's subjective initiatives should be considered in the aspects of governance structure, organizational structure, leadership and assignment of responsibility, etc.
(2) Objective criterion. The objective criterion is the link of organizational goals and the activities of controllers. The determination of objective criterion should consider variety of factors, such as historical performance, industrial characteristics, and organization goals.
(3) Control efficiency. Management control requires not only the efficiency of organization activities but also the efficiency of management control itself, that is, less investment (or cost) but more outputs (or benefits). An enterprise shall control the cost of management control and avoid the situation in which management control cost is higher than benefits.
(4) Flexibility. The flexibility of management control requires that control objectives, control standards/criterions, and control modes should be coordinated with control environment, and the personnel initiatives and creative efforts should be fully inspired.
(5) Controllability. It requires that the subject of management control is in accordance with the object of management control. An enterprise shall put controllability on an important position so that the entire management control system can operate effectively and efficiently.
(6) Comprehensiveness. Management control is a fully integrated system. The elements, procedures, contents and hierarchy of management control are correlated with each other. An enterprise shall have the overview conception in the process of the design and operation of management control.

Article 7 An enterprise shall understand management control elements and analyze management control environment at first, and then choose management control modes, lastly management control procedures and implementing management control contents.

Management control elements are the essential components of management control system, which reflect the objectives, essence and procedures of management control.

Management control contents are the specific footholds of management control system, which reflect the levels, activities and links of management control.

Management control procedures are the scientific steps when implementing management control, which reflect the decomposition of management control.

Management control modes are the system framework when implementing management control, which reflect the hierarchy and adaptability of management control.

Article 8 An enterprise shall establish and implement its management control policies in accordance with relevant laws and regulations. This Standard and its application guidelines should be implemented in accordance with the management control environment and characteristics of an organization.

Article 9 An enterprise shall apply information technology (IT) to enhance its management control practice by establishing a suitable business management information system with embedded controls in order to reduce or eliminate manual control related factors.

Article 10 The board of directors is responsible for establishing and implementing effective management control system.

Article 11 An enterprise shall monitor and assess management control system to ensure it can be implemented effectively.

2.2 Management Control Elements

Article 12 Management control, as a system, should perform one or several activities regularly or continuously. An enterprise shall understand management control elements first before management control is formulated and implemented. Management control system elements are those factors that reflect the nature of management control and all parts of management control system.

Article 13 An enterprise has to take account of the following ten basic elements when establishing and implementing effective management control:

(1) Control environment. Control environment is the environment faced by an organization when carrying out management control activities, including external environment and internal environment of the organization. An enterprise shall first analyze control environment.

(2) Control variables. The control variables are key factors that affect the strategic objectives of an organization. The successful achievement of organizational goals mainly lies in the control of the key factors such as risk factors and value driving factors that affect the organizational goals. An enterprise shall identify key control variables important for the business.

(3) Control standards. The control standards refer to the basis or yardsticks of management control of an organization. They are the quantifications of the control variables. The control standards can be divided into the budget control standards, industry control standards, historical control standards, etc. An enterprise shall choose suitable control standards.

(4) Information reports. Information reports are measuring, recording and reporting all kinds of information about the organization's activities, and they reflect what the organization is doing. An enterprise shall establish timely and effective information reporting mechanism.
(5) Executing evaluation. Execution of evaluation is the process of assessment and appraisal on an organization's activities. An enterprise shall compare information reports with control standards and analyzing them.
(6) Deviation correction. Deviation correction is the process of correcting the unfavorable variance between the actual results and control standards after evaluation. An enterprise shall correct the deviations in time after evaluation.
(7) Performance evaluation. Performance evaluation is the process of evaluating results or performance of management control. The performance of an organization may be different from that of managers. When implementing management control, an enterprise shall mainly focuses on the evaluation of the performance of the managers or controllers.
(8) Incentive mechanism. Incentive mechanism should be established in order to give a reward for good performance and punish for poor performance. An enterprise shall connect the effects of management control with the remuneration of managers to ensure the long-term effective operation of management control.
(9) Communication. Communication is the process of delivering information timely to the top management level. This is the foundation and guarantee of successful management control. An enterprise shall enhance communication in the process of management control.
(10) Monitoring. Monitoring is to monitor the quality of management control implementations, as a whole, management control system itself also needs to be controlled or supervised, which is an essential element of a sound control system.

Article 14 Management control environment is the first element of management control system. It is the basis of the other management control elements, the premise of management control procedures, the reason of choosing management control modes, and the guarantee of executing management control activities. Therefore, an enterprise shall analyze management control environment at first. The other management control elements will be introduced in the part of management control procedures and management control modes, etc.

Management control environment can be divided into the external environment and the internal environment. Both of them contain specific factors.

Article 15 The external environment of management control includes social environment, political environment, technological environment, business environment, industry competitive environment, suppliers and customers environment, etc. They have sub-factors. For example, social and political environment includes the factors of moral, culture, religion, ecology, etc.; government activities include the factors of institutions, laws, regulations, etc.; international business environment includes the factors of exchange rates, international capital markets, international trade policies, etc.

Article 16 The internal environment of management control mainly includes organizational strategy, organizational structure, responsibility center, enterprise culture and human resource, etc.

(1) Organizational strategy. Understanding organizational strategy has a critical influence on the construction of management control system. Management control complements organizational strategy because strategy formulation is the process of determining the organizational objectives and the strategies to achieve these objectives, while management control is the process to ensure the strategies can be implemented effectively.
(2) Organizational structure. An enterprise shall establish and improve the organizational structure in line with the needs of the organizational strategy. It should clarify the key functional departments in the organizational structure, and it should consider the power concentration and adaptability of the organizational structure. In addition, an enterprise shall determine whether the management personnel in different levels of the organizational structure have enough knowledge, skills and experience.
(3) Responsibility centers. An enterprise shall authorize reasonably, make a clear division of responsibility centers and match the authorities with responsibilities. The responsibility centers should include revenue center, expense center, profit center and investment center. The enterprise should have a clear delineation of the respective responsibilities. It should also analyze item by item and provide the knowledge and skills that the jobs need. All the business units, branches and employees of the enterprise shall exercise the corresponding duties specified within the authorization. The enterprise should establish an effective responsibility evaluation and incentive feedback mechanism.
(4) Human resource. An enterprise shall establish scientific human resource policies, including establishing the basic personnel management rules such as appointment, training, job rotation, promotion and elimination; building an objective, fair and reasonable performance evaluation and incentive mechanism; and establishing scientific human resource quality management rules to ensure that employee's have and maintain the quality of integrity, honesty, fairness and due professional competence.
(5) Enterprise culture. An enterprise shall establish a systematic and adaptive culture outline to create a positive and unique culture atmosphere. Specifically, an enterprise shall improve all levels of cultures including institution level, spirit level and material level; form an entrepreneurial management philosophy and operating style; and establish the principle of good faith and reasonable personal core values and corporate core values.

Article 17 To provide a basis for a good control environment, the board of directors and top management shall emphasize on the management control, put forward specific plans and requirements for the implementation of management control, establish a series of standards and processes, and require the employee in different levels to implement them seriously.

2.3 Management Control Contents

Article 18 Management control has different contents from different angles. In general, the contents of management control can be divided according to control subjects, control objects and control processes. An enterprise shall implement every specific link of management control contents seriously.

Article 19 Divided according to control subjects, the contents of management control include:

(1) Corporate governance control, the board of directors acts as the main body. Strategic management control is the main task of it, which contains enterprise objectives determination, enterprise strategy and tactics, responsibilities and rights of managers, and the establishment of oversight mechanisms, etc.
(2) Management control, in a narrow sense, the managers are the main body. It influences other members of the organization to implement the organization strategies through the managers. The objective of management control is implementing organizational strategies so that the objectives of the organization can be achieved.
(3) Activity control or task control, the employee are the main body. Ensuring the effective implementation of specific tasks is the main task of it. The rules for execution of these activities or tasks can be described as parts of the management control process. This is the basis of management control.

Article 20 Divided according to control objects/activities, the contents of management control include:

(1) Production and R&D control. The production plays a significant role in the process of creating value. Output, variety, quality and costs are closely related to production, and production control is the focus of management control. In the modern competitive market environment, R&D has a significant influence on the quality of production, costs of production, and the variety of productions. This will be possible only when enterprises strengthen the R&D control and grasp core technology, then they will survive and win the development.
(2) Procurement and sales control. The purchasing and sales are mainly geared to the needs of market. Enterprises purchase goods/services from suppliers and sale goods/services to customers. In market economy conditions, purchasing and sales control plays a significant role in the process of achieving management control objectives. Purchase control involves purchase cost, purchase quality, delivery time and payment time, etc. The sales control involves sales price, sales volume, sales costs, selling expenses, payment collection, etc.
(3) Financial control. Financial activities include financing activities, investing activities and distribution activities. Financial control should enhance the control of these three activities. Because these three controls are closely related to the creation of enterprise value, financial control is the core of management control. Financing control includes financing scale, capital structure, ownership structure

and cost of capital, etc. Investing control is concerned with investment direction, investment structure, investment risks, and assets utilization, etc. Distribution control involves compensation levels, incentive methods and dividend policy, etc.

(4) Assets and human resource control. Assets and labor are two major business resources. It is the basic requirement of management control to ensure the safety and integrity of assets and personnel. It means that the resources are efficiently utilized, without loss and waste. Accordingly, assets control includes the security and integrity of assets control, efficient use of assets control, etc.; human resources control includes human security control, human resource configuration control, labor productivity, etc.

(5) Accounting control. Accounting is an information system and a kind of universal business language. The accounting information affects financial position, operating results and cash flows of the organization. The objective of accounting control is to ensure the reliability of accounting information and to improve the relevance of accounting information.

Article 21 Divided according to control processes, the contents of management control include:

(1) Resources investment control. An entity or an organization needs both human resources and capital resources to survive and thrive. Control of resources investment focuses on human resources and capital resources. The direction, quantity, quality and structure of resource investment determine the efficiency and effectiveness of the organization operations.

(2) Supply chain control. Supply chain management is the integration of supply, production and sale. In order to get effective output, an enterprise is required to manage operation after investing resources. It suggests that the enterprise must control sales price, sales revenue and cash inflows as well as costs such as procurement costs, production costs, administration expenses and operating expenses during operating process. Control of supply chain ensures the achievement of objectives of enterprises and influences the efficiency and effectiveness of output.

(3) Output & outcome control. Output & outcome control mainly covers the effectiveness and efficiency of output & outcome. Efficiency is the ratio of output to input, including assets turnover (AT), return on equity (ROE), and profit margin (PM), etc. Effectiveness is determined by the outcome, including revenue, profit, and capital gain, etc. Control of output & outcome is a type of result control, not a kind of process control. The distribution of benefits to managers and employees is influenced and decided by the effectiveness of the result control.

(4) Benefits distribution control. Benefit distribution is distribution of output among stakeholders in a broad sense. Stakeholders include investors, managers, employees, government, etc. It is usually based on the contributions to total output by stakeholders. Benefit distribution control establishes relationship between benefit distribution and results control, that is, only when stakeholders

make contribution to the total output, can they yield profit. In its narrower sense, benefit distribution control is a mechanism in which managers are forced to make greater contributions in order to obtain profits.

2.4 Management Control Procedures

Article 22 Management control procedures should include five steps, which are decomposing strategic objectives, developing control standards, management control reports, operating performance evaluation and executive compensation, and each step involves a lot of control links and control methods.

Article 23 Decomposing strategic objectives. Strategy describes an organization overall direction to achieve its goals. To achieve the strategic objectives and make it operational, strategic objectives should be decomposed into strategy formulation, strategic planning, strategic programming and determining specific objectives.

Strategy formulation is the strategic process of determining the goals of the organization and the main strategies for achieving these goals. Strategic planning is the process of deciding on the programs that the organization will undertake and the approximate amount of resources that will be allocated to each program over the next several years and the quantity of resources that the projects need. Strategic programming means analyzing proposed new programs and determining the rational scheme (typically 1 year) of resource allocation.

An enterprise shall establish a system of management control objectives based on strategic objectives. The objectives of management control should consider the objectives of strategic control, overall operational control and specific task control.

Article 24 Developing control standards. Control standards are the specific standards that managers make reference to in controlling. The development of management control standards on the basis of the strategic planning is an important step in the implementation of effective control.

An enterprise shall develop a system of management control standards based on the system of management control objectives. This step is to decompose management control objectives into layers (through the objectives of strategic control, overall operational control and specific task control), and to determine each control variables and control standards of management control in each link.

(1) Procedures of control standards development. To be specific, the procedure of setting control standards contains the following four steps: specifying the elements that affect the organization objectives, or goal drivers; identifying significant variables that affect the implementation of strategic objectives; defining critical risk variables as the focal of control; setting advanced and feasible management control standards.
(2) The formats and contents of control standards. The formats of control standards are: quantitative standards and qualitative standards; efficiency (ratios or relative number) standards and performance (total amount or absolute number) criteria.

The contents of control standards include financial standards and non-financial standards. The most widely used financial standards are mainly budget standards. The balanced scorecard approach is a typical kind of non-financial standards.

(3) The types and levels of control standards. From the perspective of setting standards of management control, it includes empirical standards, historical standards, industrial standards, budget standards, etc.

Article 25 Management control reports. Preparation of management control reports is the key step to truly and fairly measure and reflect the true economic operation situation. In reality, management control reports are the performance reports of the entire organization and sector. The types and contents of them should be identified according to management control standards. The preparation of the internal control report should focus on the aspects of control standards, actual performance, measurement and control of differences.

An enterprise shall establish a system of management control reports based on the system of management control standards. According to the operation levels of an enterprise, management control reports should include four reporting systems, which are capital operation reports, asset operation reports, merchandise operation reports and production operation reports.

Article 26 Operating performance evaluation. Operating performance evaluation is also the evaluation of control performance. If there is no evaluation about the effectiveness of control, the enthusiasm of the controllers will be weakened. The enterprise shall build a system of evaluation management control performance based on the system of management control reports.

(1) Operating performance evaluation should follow the following principles: (a) the principle of the unity of organization performance evaluation and the managers performance evaluation; (b) the principle of the unity of operating result evaluation indicators and goal driven evaluation indicators; (c) the principle of the unity of internal evaluation and external evaluation; (d) the principle of the unity of financial evaluation indicators and non-financial evaluation indicators.
(2) There are primarily three popular methods to evaluate operating performance at present, in both theoretical and practical fields, i.e., single-indicator evaluation, indicator-system evaluation, and balanced scorecard evaluation.

Article 27 Executive compensation. The effectiveness of management control should be linked to executive compensation to ensure that the process of management control could run effectively in a long-term. Those who are motivated through compensation involve all members of an enterprise, and the most important ones are the managers. An enterprise shall establish a system of management control incentive based on the system of management control evaluation.

(1) Executive compensation mainly consists of three parts: wages, benefits and incentives. Wages should be determined according to the education background, experience, previous performance and job position of the manager. Benefits should be determined according to the total performance of the enterprise and

the job position of the managers. Incentives should be determined according to the contribution of the managers to the organization.

(2) Executive compensation should follow the following principles: (a) the principle of combining spirit incentives with material incentives; (b) the principle of combining short-term incentives with long-term incentives; (c) the principle of combining personal incentives with team incentives.

2.5 Management Control Modes

Article 28 Management control system mode reflects the mechanisms, modalities and methods of the operation of the management control system. According to the theory and the evolution of modes of enterprise management control systems, and combining with our current economic system and economic environment, as a framework, management control system modes can be classified into four modes, i.e., regulation (rule-based) control system, budget control system, evaluation control system and incentive control system. The control methods, objectives, advantages and obstacles of these four kinds of management control modes are different, and each has its own features.

The control environment is essential for the establishment and selection of management control modes. From the perspective of control environment and control authorization, the four kinds of management control modes are in four different classes. Incentive control system has the highest control authorization and requirement of control environment; next is the evaluation control system; then budget control system; and regulation control system has the lowest control authorization and requirement of control environment. According to China's current control environment, most companies require regulation control system mode to implement strategies. Budget control system mode is relatively advanced and feasible control mode which is suitable for some companies. And so far, only a few companies can adopt the evaluation control system mode while fewer companies can directly adopt the incentive control systems mode.

An enterprise shall choose the management control mode that is suitable to its control environment. On the one side, the four kinds of management control system modes each can operate as a stand-alone control system. On the other side, the same enterprise can use two or more control systems simultaneously, and they can control enterprises from the perspective of the rules, procedures, objectives and interests respectively. For instance, an enterprise group can mainly adopt budget management control system and supplemented by other control modes.

Article 29 The mode of regulation control systems

(1) Regulation control refers to regulating and limiting people behavior through the form of regulations, guidelines and other norms to achieve a certain goal. Regulation control in management control refers to regulating and limiting managers and employee's at all levels through the form of regulations, guidelines

and other norms to achieve organizational goals, and to ensure that management activities are not contrary to the realization of the organization strategic objectives.

(2) As a mode of management control system, regulation control system should include the links of regulation establishment, regulation implementation, regulation evaluation and reward. The basic characteristic of the regulation control system is controlling by means of rules or regulations.

(3) From the perspective of hierarchy, the regulation control system includes rules of strategic control, rules of management control and rules of task control. Rules of strategic control include the articles of association, enterprise's strategic planning, corporate structure, rules of corporate governance, etc. Rules of management control include financial control, human resource control, marketing control, purchase control, production and cost control, etc. Rules of task control include production processes, procurement processes, storage processes, etc.

Article 30 The mode of budget control systems

(1) Budget control refers to the process of regulating the organization objectives and economic behaviors through the form of budget plan, adjusting and modifying management behavior and target deviation to ensure achievement of objectives, strategies, policies and planning of all levels. Budget control includes the steps of the formulation of budget or budget planning, enforcement of budget, variance analysis of budget and correcting the deviations.

(2) As a mode of management control system, budget control system should include a link of budget planning, budget control, evaluation of budget and incentives of budget. The basic characteristics of the budget control system are that it emphasizes the process control and focuses on timely correction.

(3) From the perspective of budget hierarchy, the budget control system includes the enterprise's budget (enterprise group budget, subsidiary or business unit budget), department budget and project budget. From the perspective of budget contents it includes the operating budgets, financial budgets, capital expenditure budgets. From the perspective of budget preparing steps it includes defining budget content, budget control point, budget control standards, etc. From the perspective of budget methods, it includes fixed budgets, flexible budgets, zero-based budgets, incremental budgets, regular budgets and rolling budgets.

Article 31 The mode of evaluation control system

(1) Evaluation control refers to regulating the economic objectives and economic behaviors of the managers and staffs at all levels in the organization through the way of evaluation. The evaluation control emphasizes the control objectives and control results. As long as the management objectives at all levels are achieved, the organizational strategic objectives will be achieved.

(2) As a mode of management control system, evaluation control system should include the link of strategic planning, evaluation criteria (selection of criteria, standard of criteria and criteria calculation), evaluation procedures and methods,

evaluation reports, reward and punishment. The basic characteristic of evaluation control system is a kind of result control, emphasizing on results rather than processes.

(3) From the perspective of control hierarchy, the evaluation control system includes the evaluation control of senior manager by the board of directors, evaluation control of department manager by senior manager, evaluation control of project manager by department manager, and evaluation control of staff by project manager. From the perspective of control contents, the evaluation control system includes financial performance evaluation, management performance evaluation, quality and technique performance evaluation, and task performance evaluation.

Article 32 The mode of incentive control system

(1) Incentive control refers to controlling the behavior of managers by the way of motivation in the organization, so as to coordinate the behavior of managers with enterprise objectives (or the objectives of the owners). Besides regulation control systems, budget control systems and evaluation control systems, incentive control systems are also a subsystem of management control system aimed to motivate the managers to create more value for the enterprise.
(2) As a mode of management control system, incentive control system should include the link of strategic planning, selection of incentive ways, incentive constraints (contracts) and performance evaluation. The basic characteristics of the incentive control system are the alignment of interest of management and shareholders and the coordination of the objectives of the stakeholders.
(3) From the perspective of control hierarchy, the incentive control system includes incentive control from owners to top managers and incentive control from top managers to subordinate managers. From the perspective of control methods, the incentive control system includes stock option (or regarding stocks) incentive, annual salary incentive, performance-linked incentive, bonuses incentive, etc.

2.6 Monitoring and Assessment

Article 33 Management control monitoring (supervision) relates to the enterprise's monitoring of the management control, it has designed and put into operation, its assessment of the effectiveness of the management control design and operation, and timely taking measures to rectify identified control weaknesses or deficiencies.

In accordance with this Standard and its supplemental measures, the enterprise shall establish management control monitoring policies, clearly define the authorities and responsibilities of internal audit department (or another department that has charged with the monitoring role) and accountable departments and formalize management control monitoring procedures, methodology and handling mechanism.

Article 34 Management control monitoring consists of regular monitoring and special monitoring. Regular monitoring relates to the routine examination of existing management control established and operated by the enterprise. Special monitoring relates to the targeted examination of one or several aspects of management control that are affected by a significant change in the enterprise's business strategy, organizational structure, business activities, operational procedures, key personnel and other major factors.

Article 35 As management control is the management behaviors mainly implemented by the managers, the managers should be responsible for daily operation of the management control system. The board of directors or top management is responsible for the monitoring, supervision or inspection of the establishment and effective implementation of the management control system.

Those who are responsible for the oversight of management control system shall be independent, have professional integrity and competent in discharging their duties and responsibilities.

Article 36 The duties of management control monitoring are:

(1) To monitor and inspect the implementation of management control;
(2) To inspect and assess the efficiency and effectiveness of the management control system;
(3) To prepare assessment report of management control on a periodic basis, and to put forward improvement recommendations for the weaknesses or deficiencies of management control mechanism, management control contents and management control methods, etc.;
(4) To put forward measures of recognition awards for the internal departments and personnel who perform excellent in the process of implementing management control, at the same time, put forward measures of punishment for the internal departments and personnel who violates the standard of management control.

Article 37 Assessment of management control herein refers to the process performed by an enterprise board of directors or similar authority to comprehensively assess the effectiveness of the management control system, draw conclusion and issue assessment reports thereon.

In accordance with this Standard and in view of the status of the management control system's design and operation, the enterprise shall establish detailed policies and procedures for assessing management control; specify the assess principles, contents, procedures, methods and reporting modes; define responsibilities and level of authority for relevant departments or posts; implement a system of accountability; and perform an orderly assessment of management control in line with the stipulated methods, procedures and requirements.

The Board of an enterprise shall be responsible for the truthfulness and effectiveness of the assessment of management control.

Article 38 An enterprise shall at least comply with the following three principles in performing management control assessment: the principle of comprehensiveness, the principle of materiality and the principle of objectivity.

Article 39 An enterprise shall identify the detailed contents of management control assessment and comprehensively assess the management control system's design and operation covering components of management control elements, management control procedures, management control modes and management control contents, etc.

Article 40 An enterprise shall develop scientific procedures on management control assessment to perform the management control assessment in an orderly manner. A management control assessment normally includes the following procedures: developing a work plan, establishing an assessment team, performing assessment and analysis, summarizing assessment results and preparing a report.

Article 41 An enterprise shall prepare management control assessment report timely in accordance with the specified procedures and requirements, and then submit it to the Board for reviewing. An enterprise shall design the types, formats and contents of their management control assessment report themselves according to their own characteristics.

2.7 Supplementary Provisions

Article 42 This Standard is not compulsory, which can be regarded as a reference for establishing, implementing and assessing enterprise management control. The responsibility of interpreting this Standard remains within Sino-German Management Control Research Center, Dongbei University of Finance and Economics (DUFE).

Article 43 This Standard is just a kind of framework document. Application guidelines attached to this Standard are also practically useful. The enterprise shall select its suitable management control mode, and develop specific policies, rules and methods for the implementation of management control in accordance with its control environment and characteristics.

Part III
Application Guidelines for Enterprise Management Control

Chapter 3
Application Guidelines for Enterprise Management Control No. 1—Regulation Control System

3.1 General Provisions

Article 1 These Guidelines have been formulated in accordance with the relevant laws and regulations, as well as the "Basic Standard for Enterprise Management Control" to strengthen management control activities, to standardize the order of the management, to ensure organizational strategies and objectives effectively implemented and to improve the regulations of management control in an enterprise.

Article 2 "Regulation control" in these guidelines refers to guiding and limiting the behavior of managers and employees at all levels through the form of rules and regulations for the purposes of ensuring that the realization of enterprise strategic objectives. The function of regulations is to make it clear about the to-dos and not-to-dos for managers and employees. They should do things according to the rules and regulations, and do right things, which should not violate business goals.

Article 3 There are different categories of regulations according to different classification criterions. According to organizations of regulation control, it can be divided into rules of enterprise comprehensive control, rules of functional department brunch control and rules of subsidiary company control. According to elements of regulation control, it can be divided into regulation control environment, regulation control standards, regulation control evaluation and correction. Procedures or steps of regulation control can be divided into regulation formation, regulation implementation, regulation evaluation, while the hierarchy of regulation control can be divided into rules of strategic control, rules of management control and rules of task control. These guidelines are classified according to the hierarchy; regulation control system can be divided into rules of strategic control, rules of management control and rules of specific task control.

Article 4 These guidelines are mainly applied to enterprises and other economic organizations. Non-profit organizations, such as state organs, social groups and institutions, may take guidance from these guidelines when establishing and implementing their management control. The implementation intensity of these

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guidelines should be enhanced for the organization with low management infrastructure.

Article 5 The person who is in charge of enterprises and other economic organizations, governments and non-profit organizations is responsible for the establishment, improvement and the effective implementation of these guidelines.

3.2 Objectives and Principles of Regulation Control System

Article 6 The objectives of regulation control system include fundamental objectives and specific objectives as follows.

(1) The fundamental objectives of regulation control system are to standardize and guide the behaviors of managers and employees at all levels of organization and to ensure that the management activities are not contrary to the organization strategic objectives through constructing the representational system contained the enterprise purposes and goals. Irrational design of the system, ineffective combination of authorities and responsibilities may lead to ineffectual system framework and difficulties in achieving strategic objectives. The enterprise shall address, at a minimum, all the risk mentioned above.
(2) The specific objectives of regulation control system include efficient operations, asset security, error correction and prevention, and relevant laws and regulations compliance.

Efficient operations are the core objective of regulations. In order to achieve strategic objectives, managers formulate certain procedures and rules to ensure that all employees of the enterprise could comply with these procedures and rules to some extent. Through the formulation of management control rules, enterprise can coordinate, supervise, inspect and examine managers of each department reasonably, to ensure that each activity is in accordance with the provisions of the control program and achieves the purpose of promoting the operation of business activities effectively and efficiently.

Asset security objective is the basic objective of regulation. Restraining each other through the management control rules can prevent corporate fraud and assets loss effectively. A strict authorization can ensure the security and integrity of assets in the process of using goods or other assets. A lack of effective operational mechanism and execution capability of the system may lead to duplication and inadequacy in roles and responsibilities, and assets loss. The enterprise shall address these risks.

Error correction and prevention is the direct objective of regulation control system. Monitoring the management control rules can prevent the potential risks of the enterprise effectively and compensate the deviation in the management process. Through comparing the actual performance and planned objective, the results of the comparison should be communicated to relevant management timely. In order to

achieve error correction and prevention objective, it is necessary to analyze the deviation of actual performance with planned objective and take correction measures.

Relevant laws and regulations compliance objective is the lowest objective of regulation control system, and they are the premise and guarantee of all the activities of enterprises. Regulation control system requires that all employees should engage in business activities within the limits of relevant laws and regulations, to guard against illegal behavior, and to ensure legal compliance.

Article 7 The principles of regulation control system are as follows.

The objective law and basic rules must be followed to build the regulation control system, which are known as the basic principles of the regulation control system. It includes the systematicness, the suitability, the holistic, the prioritization, the cost and benefit analysis, and the legality.

(1) The systematic principle is that organizations should make regulations from the angle of enterprise's strategic goals. Apart from formulating reasonable regulation, organizations should also design details rigorously to guarantee the system's application. There are not only penalty rules in the regulation, appropriate incentive rules should also be involved, which can avoid inhibiting staff's creativity.
(2) The suitability principle means: on one hand, the organization should formulate the regulation according to their actual situations; on the other hand, the organization should appropriately respond to environmental changes, and bring advanced management methods and concepts into the timely.
(3) The holistic principle refers to that regulation control system shall encompass the whole process of management activities as well as all operations and transactions of the enterprise and its affiliates. Managers should take full account of the industry background, scale of operation, management level and other factors to develop a comprehensive regulation control system.
(4) The prioritization principle is relative to the strategic objective. In the context of an enterprise's overall regulation control system, all key factors which have a significant impact on the strategic objective, are needed to be controlled through establishing a corresponding system.
(5) The cost and benefit principle is another important principle. It is necessary to pay a certain cost to establish and implement the regulation control system, and the cost may be very high in some cases. In addition, the supervision of the regulation control system also generates recurrent expenditure. So it is necessary to evaluate the cost-effectiveness of the regulations and obtain the maximum economic benefits with minimal control or management costs from the establishment of the regulation control system.
(6) The legality principle is a rigid principle. Organization is subject to certain environmental constraints, especially legal environment constraints. Therefore, the regulation control system should operate within the limits prescribed by law. Any systems should not transgress the law.

3.3 Rules of Strategic Control

Article 8 Rules of strategic control are to define, implement and control the organizational strategy to assist the organization to achieve its objectives. It aims at comparing the intended target (standard) with practice feedback results, detecting the degree of deviation and evaluating whether it meets the intended objectives and requirements. Then, the organization can take timely action when the problem is discovered.

Rules of strategic control include the articles of association, the enterprise strategic planning, the enterprise organizational structure and corporate governance. Different subsystems contain different contents and these specific contents are needed to be paid more attention by the enterprise.

Article 9 The articles of association which have controlling and binding force on the enterprise's management and staff, are the guidelines to adjust the enterprise's internal relations and economic behaviors norms. As an important part of the rules of strategic control, it is the basic norm of the organization and conducts of the company as well as a legally binding charter. It is the statute of autonomy of the company's strategic control and the backbone of the company's management control system. All the staff in the enterprise must serve and obey the articles of association.

The specific contents of the articles of association should be stated: general provisions, that is the purpose and basis of the formulation of the articles of association; the business objectives and scope of enterprise; the registered capital of enterprise; the names, amounts and mode of the capital contributions of shareholders; the rights and obligations of shareholders; the conditions to transfer the share of investment of shareholders; the company structure and its formation, powers, term of office, and rules of procedures; the legal representative of enterprise and its powers and functions; the system of financial accounting, profit distribution, auditing and labor employment; the way of merger, division, dissolution and liquidation; and other matters provided.

Article 10 The enterprise strategic planning is to make the overall planning of the enterprise. It should set up overall objectives for the organization. Strategic planning includes four parts, involving planning basis, planning body, planning implementation and planning review. These contents are objective managements at the core of strategic planning and are set up on the basis of adapting to the environment inside and outside the enterprise. It covers all business activities of enterprise and should be modeled regardless of the organization and the size of enterprise.

The formulation of the strategic plan includes the following steps:

(1) Determining the organizational objectives and overall action programs to achieve the objectives. The essence of this step is decision-making which is to determine the organization's objectives, clarify the specific prerequisite of planning, propose a variety of options to choose from and determine the optimal or the most satisfactory solution.

(2) Decomposing the objectives to form a reasonable objective structure. This step requires doing a lot of industrial research based on the access to information, making analysis model that suits the business characteristics, developing sub-sector and phased objectives and proposing strategic planning for the first time. Decomposition objectives to each responsibility point can not only ensure the consistency of the objective and provide a basis for the resources organization and distribution, but also can form a common uniformity or organizational atmosphere and specify the direction of the work.
(3) Developing specific plans of the strategy implementation, and analyzing and revising it. When making strategic planning, enterprises should ensure the combination of the annual plan and strategic planning. The long-term plan of the enterprise will work out through in-depth analysis by the general managers of the planning department, the departments of the market, production and other aspects. The annual plan is the short term plan which has feasibility, regarding the financial budget management and objective responsibility system as support of the annual plan, and analyzes the balance of different segments between the different stages of the tasks and capabilities, that is to research if all parts of the organization have sufficient capacity to complete the required tasks at anytime. If the final annual plan does not show apparent profit possibility, the lack of coordination will occur. The existence of these problems should be solved through the revision of the long-term plan.
(4) Auditing and approving. Company executives may spend considerable time and efforts in discussing the amendment of plans. These plans may be submitted to the board of directors for consideration, and finally be audited and approved by the CEO.

Article 11 The enterprise organizational structure is the basic form or framework of the organization internal labor division. The organizational structure of company can be divided into the pyramid functional organizational structure and flat efficient organizational structure.

(1) The pyramid functional organizational structure is an organizational structure which ensures the effectiveness of information transfer through its rigor organization, strict systems and unambiguous levels of hierarchy. It builds a relationship of control and being controlled, and an inter-relationship of command and obedience between managers and the managed. It is a pyramid-like organizational structure based on longitudinal coordination predominated and horizontal coordination supplemented. It mainly includes three forms.

The first mode is matrix organizational structure. This organizational structure is a double linear vertical leadership system, and one employee is under the lead of two managers at the same time, showing a cross-leadership relationship. This organizational structure solves the problem of departmentalized and poor coordination of departments to a certain extent, but there are some big problems also, that is, the two executives both consider the interest of their core staff, so clearly there is a conflict of interest between them.

The second mode is business unit organizational structure. This organizational structure presents the relationship formed through the independent activities of a number of business units, which are set up under the leadership of the top executives, based on product or operational area. This organizational structure makes enterprise headquarters free from the heavy day-to-day operations and so it pays more attention to supervising, coordinating the business activities of the departments and evaluating the performance of the business units, which makes each subsidiary maintain greater independence. But to some extent the independence of this organizational structure is too strong, and lacks necessary strategic links and coordination. The business unit structure enables enterprises to produce so many management hierarchies, which makes the characteristic of the “pyramid” type more prominent.

The last mode is multi-dimensional organizational structure. This organizational structure is the synthesis of the matrix organizational structure and business unit organizational structure. It usually consists of three types of management systems: the first type is business unit divided by product; the second division is by management functions; the third is division on geographical biases. This organizational structure enables management agencies to enjoy relative autonomy. Every employee within the enterprise may be managed by different departments of the organization. It is not only difficult to get along with, but also difficult to manage on account that each employee has three bosses, and the work may compete for resources in the same department.

(2) Flat efficient organizational structure can increases decentralization, reduces management hierarchies, improves the efficient transfer of information, pays attention to increasing the flexibility and creativity of organization and improves the operating efficiency. This organizational structure can relieve the workload of senior managers and inspire the enthusiasm of the staff. It mainly consists of two organizational modes:

One is on the biases of business processes. This structure is highly flexible which gathers marketing, production, process design together. It is mainly to build a multi-functional cross-level project structure and team based on computer networks. Each functional team or individual can share information through the computer platform, thereby understand and maximize the overall strategic planning and objectives of company timely. The characteristic of this organizational structure is that it not only shortens the decision-making cycle, saves costs, improves labor productivity and provides maximum freedom to the work of the employees, but also reduces the loss of information to a minimum within the organization and achieves the management control objective better.

The other is boundary-less organization. This structure is able to make people who have different expertise solve all kinds of complex problems creatively through the exchange of ideas. There is no fixed process of information transmission within the organization and there is also no clear boundary. Organizations can exchange energy with the outside world at any time and can receive franchisees at any time. The organization will be dismissed after the task is completed. Its basic spirit is to break through the boundaries of the enterprises, use the strategies of external

resource integration and exercise all the functions needed in an organization through the virtualized union. It pursues a shorter product development cycle, reduces risk and provides strategic flexibility, which makes an organizational structure more suitable for environmental changes and suitable for the management control characteristic.

Article 12 Corporate governance mainly refers to a set of institutional arrangements to control, coordinate, supervise, reward and penalize the management and performance by the enterprise owners. Through coordinating the interest relationship between the company and all stakeholders, the enterprises can reduce agency costs and agency risk, prevent the manager deviating from the interests of the owners and ultimately safeguard the interests of all aspects of the enterprise.

The basic contents of corporate governance include the following aspects:

(1) The basic norms for the rights of shareholders and the shareholders meeting. Shareholders enjoy legal rights under the laws, administrative regulations and the articles of association as the owner of the enterprise, and the rules of governance structure should ensure the equal rights of all shareholders. The shareholders enjoy the right to know about and the right to participate in the significant events of the enterprise under the laws, administrative regulations and the articles of association. Shareholders are entitled to protect their legitimate rights and interests in accordance with the provisions of the laws and regulations through civil litigation or other legal means. Once the general meeting and the resolution of the board of directors violate the provisions of the laws and regulations and the legitimate rights and interests of shareholders, the shareholders have the right to bring a suit according to the law.
(2) The norms for the selection process and obligation of directors, the composition and duties of the board of directors, the rules of procedure of the board of directors, the independent director system and the main responsibilities of the special committee of the board of directors. These guidelines will help form a good board structure and operation mechanism. It will also fully guarantee the independence of the operation of the board.
(3) The norms for the duties of the board of supervisors, the constitution and rules of procedure of the board of supervisors. The board of supervisors shall be responsible for all shareholders and monitor the legality and compliance of the duties of the company finance, company directors, managers and other senior management personnel to safeguard the legitimate rights and interests of the enterprise and the shareholders.
(4) The norms for the performance evaluation of directors, supervisors, managers and the appointment of managers. It emphasizes on establishing a fair and transparent performance evaluation criterion and procedures for directors, supervisors and managers, making the salary and performance assessment closely linked, ensuring the transparency of the establishment of the compensation schemes and avoiding "self-dealing" behaviors.
(5) The norms for the disclosure and transparency of information, the disclosure of ongoing information of the enterprise, the disclosure of corporate governance information and the disclosure of shareholders' equity.

3.4 Rules of Management Control

Article 13 Rules of management control are to identify important aspects that affect the execution of strategic objectives on the basis of clearing objectives drivers, to identify key risk variables as a control point, thereby set and develop advanced and viable strategy planning and budget. It focuses on the performance evaluation of managers or controllers as well as improving the efficiency and effectiveness of operating activities.

Rules of management control include: rules of financial policy, rules for personnel, rules of purchasing control, rules of marketing control, rules of production and technology control and rules of cost control.

Article 14 Rules of financial control consist of basic financial management, capital management, asset management and financial and accounting department management.

(1) Basic financial management include internal check, internal audit, financial revenue and expenditure approval, original records management, quota management, measurement and acceptance check, property inspection, financial reporting and financial analysis, accounting archives management and computerized management.

The first is rules of internal check. This is a general term of regulations, methods and procedures to maintain the assets of the enterprise. Its purpose is to ensure the accuracy and reliability of the accounting records and make a comprehensive plan, control and evaluation system of economic activity. These rules should carry out the principles of the institutional separation, duty separation, money separation and business processing institutionalized. It should focus on the control of income and expenditure activities, the management of chop notes and warehousing sector logistics activities. These rules are applicable to all aspects of the enterprise. The enterprise must establish and improve the rules of internal check to adapt to the economic activities and operational management of the enterprise.

The second is internal audit. Internal audit is to designate to audit and review the accounting documents and journals. Accounting documents, books, reports, financial planning and the consistence of property and supplies are high-risk audit areas.

The third is rules of financial revenue and expenditure approval. These rules are regulations of the formation of financial income and expenditure plans, the approval authority, approval process and liability. To establish and improve the rules of financial approval is the key component of financial accounting work.

The fourth is rules for original records management. The original records are the basic link of the accounting work, including the original records of materials, the original records of production, the records of the finished products, personnel and payroll records, and financial accounting records. The unit should regulate the format and filling method of the original records depending on the circumstances.

The fifth is rules of quota management. The quota is the standard the enterprises should be up to when using human resources, material and financial resources in the

production process. Quota management is to develop a scientific and reasonable labor quota, the consumption quota of a variety of materials, costs quota, quality quota, fixed assets using quotas, material reserve quota, etc.

The sixth is rules for measurement and acceptance. These rules are the regulations for staff inspecting the quality and quantity of property and materials using various means.

The seventh is rules for property inspection. The enterprise should check the property on a regular basis to ensure that the accounts match the reality. The enterprise should develop different property inspection methods and provide proper disposal methods according to different objects such as cash, bank deposits, inventory and fixed assets.

The eighth is rules for financial reporting and financial analysis. Financial reports are the written documents that reflect the financial position, financial performance and cash flows for in a certain period, including balance sheet, income statement, cash flow statement, the relevant schedule and the condition of affairs. Financial analysis is to analyze the realization, operations, profitability and solvency of the enterprise, using factor analysis, comparative analysis and other methods based on the financial report, then submit analysis reports to evaluate the past, measure the present and predict the future.

The ninth is rules for accounting archives management. Accounting archives are historical data and evidences of recording and a reflection of economic business. The enterprise must develop clear rules for filing, consulting, confidentiality, destruction and other aspects of accounting archives.

The last is rules of computerized management. Computerized accounting is the direction of development of the accounting work. The enterprise should develop management rules concerning the establishment of the computerized accounting positions, the management of computer hardware and software data and the management of operation procedures and computerized accounting files.

(2) Rules of capital management include rules of capital budget and final accounts, rules of financial settlement center management, rules of loan guarantees management, rules of financing management, rules of investment management and rules of profit and its distribution management.

The first is rules of capital budget and final accounts. In order to encourage the enterprise to be able to coordinate and use funds flexibly to improve their economic efficiency, the financial sector should make the yearly (or monthly, quarterly) capital budget and final accounts of enterprises in conjunction with the relevant business departments.

The second is rules of financial settlement center management. Financial settlement center is a financial services institution. It is the internal department which is set up to adjust the respective capital surplus and deficiency of departments, centralize financial advantage and improve the effect of fund utilization. These rules should define the roles and responsibilities of the financial center, the management structure and the duties, capital settlement management approach and internal loan management approaches clearly.

The third is rules of loan guarantees. In order to reduce the risk of guarantees and ensure the safety and value-added of the assets, units should formulate the regulation to the guarantee objects and scope, guarantee conditions, guarantee approval and processing, guarantee management and irregularities responsibility.

The fourth is rules of financing management. In order to meet the normal production and operation need of various departments in the units, the enterprise must raise the needed funds. Owner's equity financing and debt financing are the major sources of funding. It is necessary to strengthen the management of the owner's equity and liabilities. Management of the owner's equity is about the investment of capital, the preservation of value-added and changes, capital reserve and surplus reserve. Liability management is to strengthen the management of long-term liabilities and current liabilities.

The fifth is rules of investment management. These rules are to regulate the investment policy from three aspects of investment feasibility study, internal investment management and external investment management.

The last is rules of profit and its distribution management. These rules consist of rules of target profit management, rules of profit realization management and rules of profit distribution management.

(3) Rules of asset management include rules of monetary asset management, rules of inventory management, rules of fixed asset management, rules of management for construction in progress and rules of intangible asset management.

The first is rules of monetary asset management mainly include rules of cash management, rules of bank deposit management, and rules of foreign currency business management. Rules of cash management prescribe for the range of cash usage, limits for cash on hand, provisions of the cash receipts and payments, cash accounting and checking. Rules of bank deposit management prescribe for the range and methods of bank settlement, accounting of bank deposits and the management of check. Rules of foreign currency business management prescribe for the management of the foreign currency assets and liabilities and the calculation of the exchange gains and losses.

The second is rules of inventory management. In order to reduce the capital occupation and ensure the safety and integrity of inventory assets, the enterprise shall establish and develop a series of systems including pricing, acceptance check, issuance, custody and inventory.

The third is rules of fixed asset management include the valuation and depreciation of fixed assets, labor division and responsibilities of the fixed assets management, the daily management, the change management of fixed assets, etc.

The fourth is rules of management for construction in progress include feasibility analysis of the construction in progress, rules of project approval system, rules of purchasing and custody of materials, supplies and equipment, rules of construction-in-progress management, rules of project completion acceptance and settlement, construction-in-progress accounting, etc.

The last is rules of intangible asset management consist of rules of intangible asset pricing and acquisition management, rules of the daily management and rules of the transference management.

(4) Rules of finance and accounting department management include rules of finance and accounting department establishment, rules of accounting leadership responsibility, rules of accounting post responsibility and rules of finance post responsibility.

The first is rules of finance and accounting department establishment. Finance and accounting department generally include chief accountant, treasurer, the accounting department and the finance department. Accounting and finance department shall properly classify all functions, and set up corresponding positions.

The second is rules of accounting leadership responsibility include the powers and responsibilities of the main responsible persons, the chief accountant and chief financial officer of the enterprise.

The third is rules of accounting post responsibility mainly make specific provisions for the job responsibility of the chief accountant, cashier, material accounting, come-and-go accounting, payroll accounting, expenses and costs accounting, accounting records management, general ledger statements, etc.

The last is rules of finance post responsibility mainly make specific provisions for the job responsibility of the chief financial officer, integrated financial management, cost management, financial audit management, financing, outbound investment, cash flow accounting and management, fixed asset accounting and management, profit management, etc.

Article 15 Rules of personnel control include rules of human resource planning, rules of post analysis, rules of staff recruitment, rules of incentive, rules of education and training, rules of employee compensation, rules of performance evaluation, rules of team building and career management.

(1) Rules of human resource planning. Rules of human resource planning adopt the basic principles of management for the planning of labor demand in enterprise. Namely, according to the changes of environment, an enterprise's proposes demand planning of staff based on the forecast of future career development. These rules mainly provide for the role of human resource planning and the procedures of developing human resource planning, human resource supply and demand forecasting methods.
(2) Rules of post analysis. Rules of post analysis are to determine the positions of the tasks, activities and responsibilities, also known as position analysis in China. These rules should mainly provide for job analysis functions, procedures, and methods and contents of the job description.
(3) Rules of staff recruitment. Rules of staff recruitment mainly make provisions for recruitment procedures and recruitment methods.
(4) Rules of incentive. Rules of incentive usually can motivate the work enthusiasm of employees, as well as to stimulate and encourage employees to achieve

organizational goals. Incentive rules mainly make provisions for the basic requirements and functions of incentive and various incentive methods.

(5) Rules of education and training. Rules of education and training mainly make provisions for basic goals, levels, methods and principles for education, training, etc.
(6) Rules of employee compensation. Rules of employee compensation include basic wage policies, bonus incentive policies and employee benefit policies. These rules make provisions for the elements, principles and methods of the above three parts.
(7) Rules of performance evaluation. Rules of performance evaluation mainly set up the purposes, principles, procedures and methods of performance evaluation.
(8) Rules of team building. These rules mainly provide for the types and goals of team building, team building process and team building evaluation.
(9) Rules of career management. Through design of the employee's work and career development plans, and coordinating individual needs and organizational needs, career management can realize common growth and development for both personal and enterprise. These rules mainly include career self-management, career plan, career path management and career cycle period management.

Article 16 Rules of purchasing control include rules of purchasing plan, rules of purchasing decision-making management, rules of bidding and purchasing management, rules of price supervision, rules of quality inspection and supervision, and rules of payment and acceptance.

(1) Rules of purchasing plan. Making material purchasing plan is to ensure continuity of production and operation, reduce capital occupation as little as possible and prevent the backlog of goods and materials. Material purchasing plan must include material names, specifications, models, units, quantities, price ranges, and be submitted to the authorities for approval.
(2) Rules of purchasing decision-making management. The enterprise could set up purchasing management team, which is mainly responsible for deciding purchasing material price, quality and supervision, and could adopt hierarchical and decentralized management according to the purchasing categories and prices.
(3) Rules of bidding and purchasing management. These rules make provisions for bidding and purchasing of materials, objects, and bidding process.
(4) Rules of price supervision. Purchasing management team supervises price through an auditing purchasing plan, purchasing price and purchasing bills.
(5) Rules of quality inspection and supervision. Quality inspection personnel should check out the quantity and quality of purchasing goods. Untested materials or goods that are not up to the standard can not be legally stored and settled.
(6) Rules of payment and acceptance. These rules mainly consist of the acceptance and payment procedures.

Article 17 Rules of marketing control include rules of sales management and rules of accounts receivable management.

(1) Rules of sales management mainly include sales forecast, sales plan, sales contract, approval and cancellation management and sales return and allowance management.
(2) Rules of accounts receivable management include responsibility of handling persons in charge of accounts receivable, the account management of accounts receivable, the collection of accounts receivable and the handling of bad debt losses.

Article 18 Rules of production and technology control include rules of production planning management, rules of production technology management, rules of production elements management, rules of logistics management, rules of product management and rules of quality management.

(1) Rules of production planning management mainly prescribe for all kinds of indicators, programming and principles to be followed in the process of preparing production planning. It usually includes a long-term production planning management system and a short-term production planning management system.
(2) Rules of production technology management mainly include the tasks, plans and contents of the production technology management. These rules mainly prescribe for the improvement, introduction, assignment of production technology, etc.
(3) Rules of production elements management mainly include the personnel organization management and production equipment management. The personnel organization management mainly provides for tasks and contents of the personnel management and divisions of labor and collaboration. It also makes detailed provisions for the responsibilities of the various production jobs. The production equipment management mainly makes provisions for the tasks and contents of equipment management, choosing and evaluating the equipment and the usage, maintenance and renovation of equipment.
(4) Rules of logistics management provide for the basic tasks and main contents of the logistics management, and determine the consumption quota and the reserves of various materials scientifically and legitimately.
(5) Rules of product management consist of products (semi-finished products) and finished goods management and the product development management. It promotes to manage the circulation and statistics of work in products and inventory products, determine the reasonable reserves of semi-finished products and WIP, inspect the rate of complete sets and enhance storage management. These rules facilitate to develop new types of products, decide the development direction, determine the product development strategy and the approach and process of new products, etc.
(6) Rules of quality management should make provisions for the product quality indicators, product quality standards, quality control of the designing trial

process and manufacturing process, quality control of the usage process, the concepts, functions, contents and operation forms of the quality assurance system.

Article 19 Rules of cost control include rules of cost management, rules of cost plan and responsibility, rules of cost accounting and control, rules of cost analysis and appraisal and rules of mutual check of various business units.

(1) Rules of cost management include correctly dividing the cost expenditure limits, determining the scope of costs, establishing strict material receiving management and rules of vouchers and books management, etc.
(2) Rules of cost plan and responsibility. The enterprise should determine the target cost on the basis of the target profit at first, and then analyze target cost according to the product and cost project, and set up consumption quotas of projects and planned cost of products. Target cost should be layer upon layer decomposed to the workshop, teams and individuals. Cost accounting, cost control, cost analysis and cost evaluation should be implemented according to the responsibility centers.
(3) Rules of cost accounting and control. Cost accounting refers to using category costing and process costing or other methods to collect and distribute costs and expenses. Cost control based on the target cost responsibility system and the cost standard implements strict accounting and auditing for the actual production cost. There are many types of cost control, such as hierarchical control and centralized control, comprehensive control and all staff control, advance control, intermediate control and afterwards control.
(4) Rules of cost analysis and appraisal. Cost analysis is to evaluate and summarize cost formation information, find out the factors that influence the cost variation, reveal the reason of the saving and waste and seek further direction and ways to reduce costs. Cost assessment taking enterprise cost plans as standard and based on complete and reliable cost information evaluates the performance of each responsibility unit and is combined with rewards and punishment system.
(5) Rules of mutual check of various business units. By mutually supervising and inspecting the costs and expenses between the financial department and the various business departments in the process of management and control, the enterprise can reduce the likelihood of errors and frauds.

3.5 Rules of Task Control

Article 20 Rules of task control are to monitor the activities of the relevant departments and persons to ensure the smooth implementation of the budget plan. Task control focuses on management over manager behaviors of the responsibility centers.

Rules of task control refer to standardization of activity behavior by the managers of the responsibility center. It mainly includes rules of production process control, rules of purchasing process control and rules of storage process control.

Article 21 Rules of production process control mainly include rules of process planning, production planning, production supervision, consigned processing, product quality supervision, manufacturing supervision, maintenance, safe production, production cost.

(1) Rules of process planning shall focus on the followings. According to the product design and standard procedure instructions, the enterprise should determine the most economic plan on existing machinery and equipment, tools, parts and processes of human resource. R&D department should analyze the product to determine the specifications and quantities of the expected materials required by the product and decide manpower required by each process. According to the cost analysis, the enterprise should determine the economic production quantity of each product; check whether processing procedure and assembly procedure are appropriate, and whether the working procedures and methods are standardized or not; check whether direct materials are effectively used to make the waste reduction to the minimum. To make sure staff working methods and the use of machinery, equipment and other design are accordance with the process.
(2) Rules of production planning shall focus on the followings. The enterprise must understand the design of the product, the production operation standard and the necessary machinery equipment, tools and manpower before formulating the production plan in order to make sure the production plan is prepared to maximize economic efficiency. Production schedule need to coordinate the production conditions and keep control for the reasonableness of the marketing. Check regularly the implementation of the production plan, if there are changes in materials delivery date or business requirements, it should timely determine whether you need to revise, and coordinate with each unit.
(3) Rules of production supervision shall focus on the followings. Output conditions for each period should be recorded, and abnormal situation should be dealt with immediately. Comparison between expected progress and actual progress should be conducted regularly, and then production schedule should be timely revised. When engineering department changes production design or customer changes requirements, it should be communicated quickly to production departments and be corrected timely.
(4) Rules of the consigned processing shall focus on the followings: whether consigned processing has its necessity and whether its cost is more favorable than the home-made's should be checked; whether consigned processing is operated in accordance with the processing procedure, related regulations, contracts are settled, the standard of quality, delivery and receiving and other relevant provisions that are documented in the contract should be checked.
(5) Rules of product quality supervision shall focus on the followings. For preventing the defective production mixed with the normal production, it is necessary to focus on the inspections of materials quality records in the past. The enterprise

should mainly check the following conditions. Whether the operating procedures are conducted in accordance with specification of the testing and operating standards; whether workers' action is in accordance with the job quality system; whether there is any improvement in nonperforming problems; whether production machines are regularly inspected, maintained and corrected; whether production personnel carry out the random sampling in the manufacturing process; whether inspection process is in accordance with the inspection specification and record timely; whether there are reviews and improvements in dealing with customer's complaints and whether the causes of defective products are analyzed, reviewed and removed.

(6) Rules of manufacturing supervision shall focus on the followings. Check whether the material is used effectively so as to reduce waste to a minimum level, check whether manufacturing procedures and methods are standardized and whether the schedule of material and production plan are effectively coordinated.
(7) Rules of maintenance shall focus on the followings. Department heads should verify their own facilities' maintenance, abnormal circumstances and scrap material monthly and trace the cause of the fault and come up with solutions.
(8) Rules of safe production shall focus on the followings. Industrial safety operations should comply with the labor law. Unit should establish operation procedures and work contents. It should be made sure that whether working methods which are simple but not safe exist and whether each member complied with safety rules and is protected safely. Meanwhile, the air and water pollution prevention facilities should be perfect, as well as the improvement measures should be taken.
(9) Rules of production cost shall focus on the followings. Check whether the calculation of direct materials cost and direct labor costs belongs to the right cost category; whether manufacturing cost is reported in the scope of accounting system and tax law presentation and whether allocation of manufacturing cost is complied with the relevant provisions. The enterprise must understand whether the cost calculation method is correct, whether requisition, refunding procedures of materials and valuation methods comply with the regulations, etc.

Article 22 Rules of purchasing process control mainly include rules of requisition, rules of purchasing, rules of the acceptance, rules of payment a and rules of insurance.

(1) Rules of requisition shall focus on the followings. Procurement staff should regularly check whether the requisition amount is in line with the economy purchasing amount and the warehouse management department should check inventory material at any time. When the amount is less than safety stock inventory or when it reaches the right point of purchasing, procurement staff should immediately fill out the purchase order, and make purchase application. When there is an emergency purchase, relevant personnel should make sure the reasonableness of the purchase first and handle it.

(2) Rules of purchasing shall focus on the followings. Managers should identify that the supplier record is updated at any time. Make sure that the price data collection is complete and the planned purchasing is consistent with plan contents. Inspect whether the contracts and documents are under processing, whether purchase order and related contract documents are checked by staff other than the procurement department.
(3) Rules of the acceptance shall focus on the followings. Managers should check whether the communication between departments is in a timely manner, or the vendor prepares necessary invoices and documents to facilitate the acceptance. Verify whether the quantity of received invoice is consistent with the actual deliveries. Check whether the warehousing sector has properly documented acceptance of products; whether warehousing lists are approved by the person in charge and whether the goods have not been accounted while they have been accepted. When the goods have been returned and discounted, responsible unit should approve and notify the accounting department to bill the corresponding voucher.
(4) Rules of payment shall focus on the followings. Relevant personnel should check whether domestic procurement vouchers have been accepted and checked before request payment; whether costs vouchers associated with abroad procurement are complete and correct. Verify whether subsidiary ledgers of accounts payable and bills payable have been set up, and check the general ledgers on a regular basis. Check whether the original vouchers attached to the recording, written-off, withdraw and adjusted for prepayment, have been approved and whether the contents are normal, and whether cashiers have reviewed related vouchers and make sure the completeness of related vouchers before payment and whether the internal control on approval of payments is actually executed.
(5) Rules of insurance shall focus on the followings. Relevant personnel should check whether approved insurance sum is appropriate, and whether the project is appropriate and all sorts of insurance rights and obligations are clear.

Article 23 Rules of storage process control mainly include rules of storage materials warehousing, rules of storage materials maintenance, rules of picking, returning materials and waste disposal and rules of material check.

(1) Rules of storage materials warehousing shall focus on the followings. Whether all kinds of materials warehousing are strictly in accordance with the prescribed procedures should be checked. The staff should examine whether material packages have corresponding company logo, whether there is clear identification on the packing material, goods name, and specification number and whether material packages match the physical check. Check the appropriateness and safety of storage site and the quantity accuracy.
(2) Rules of storage materials maintenance shall focus on the followings. Check whether the materials have entered into the warehouse storage by library classes and item codes; whether spare materials and warehouse materials are stored separately; whether personnel pay attention to the security of the storage

environment, and whether the entered vouchers are completely controlled and filed in accordance with prescribed storage life.

(3) Rules of picking, returning materials and waste disposal focus on the followings. Check whether the warehouse personnel prepare the materials according to the stock preparation and indicate the material number, quantity and size; whether materials are placed at the specified range. The enterprise should supervise and inspect whether the picking and returning procedures are sound, and verify whether the returning materials are specified in details on the returning bill and pay attention to whether setting of the idle, scrap and defective material is settled. Analyze whether the causes of the waste are reasonable, and whether the situation could be improved.

(4) Rules of material check focus on the followings. The enterprise should conduct regular and irregular spot checks. Sampling inspection by personnel should be objective and fair. Inventory work must be implemented, and make sure accounts comply with the reality. For large amounts of broken goods, the warehousing department should collaborate with the auditors to find out reasons and propose the solution.

3.6 Procedures and Methods of Regulation Control System

Article 24 The regulation control system has its own procedures. From the perspective of control procedures, regulation control system consists of five aspects, which are regulation control objectives decomposition, regulation control standard development, regulation control reports, regulation control evaluation and regulation control rewards and penalties. As a mode of management control systems, regulation control system must be based on clear understanding of the relationship between strategic plan and regulation control objectives before establishing the regulation control system.

Article 25 Strategic plan and regulation control objectives decomposition:

The strategic plan is applied to the whole organization. It sets up the overall goals for the organization, and is the basic link of management control system. Regulation control objective is the starting point of regulation control system, it should serve the realization of organization's overall objectives, and its fundamental objective is to regulate and restrict the behaviors of the management at all levels and the staffs in business activities, to ensure the realization of strategic objectives smoothly. In management control system, it achieves the objectives of management control which is to ensure efficiency and effectiveness of operating activities by establishing rules. Therefore, when setting regulation objectives, strategic objectives should be given priority. For this reason, specific objectives of regulation control should be based on strategic plans and be decomposed to every stages of production and operation management.

Article 26 Regulation control standard development:

The fundamental objective of regulation control is to achieve organization goals. From the level of specific enterprise running, this goal can be regarded as regulation control standard. Therefore, formulating regulation control standard on the basis of strategic plans is an important step to implement controls effectively.

To formulate regulation control standard, it needs the following procedures:

(1) Identifying the influence factors or drivers of regulation objectives.
(2) Finding out important variables affecting the execution of regulation objectives.
(3) Determining the key factors affecting regulation control objectives and paying more attention to control these factors.
(4) Making reasonable and feasible regulation standard. Regulation control standard should be diverse and explicit with both qualitative analysis and quantitative analysis, integrated application of financial indicators and non-financial indicators.

Article 27 Regulation control reports:

Regulation control reports are not only the outputs but also the conclusive documents of the regulation control system. Examiners obtain the information related to the examining subjects through accounting information systems and other information systems and then get the examination index data or implementation of the examining subjects after processing and sorting. Compare the data or implementation with the appraisal standards, analyze the differences, find out the causes, responsibilities and effects of the differences, draw the conclusion about the strengths and weaknesses of examined subjects' performance and then prepare the final examining reports.

Article 28 Regulation control evaluation:

Regulation control evaluation can be summarized in two parts, soundness evaluation and validity evaluation.

(1) Soundness evaluation generally has three meanings: first of all, the regulation control system should run through the whole process of management activities. Each of the management activities should have regulation control practice. Second, regulation control systems should be mastered by all departments and personnel. Third, regulation control practices are systemic. Regulation control system is formed by various administrative departments. By coordinately playing their respective roles in accordance with the specific goal, the system can achieve the overall objectives of management control and function.
(2) Effectiveness evaluation typically has two meanings: the first is the effectiveness of the regulation control itself. On the one hand, regulation control system should comply with national laws. The regulation control system should reflect national laws and policies; on the other hand, along with the change of the internal environment such as company strategic planning, budget management and management idea, the regulation control system shall be conducted in a timely

manner to improve or revise. The second is regulation control practices should be implemented and enforced effectively. All divisions of the company and all employees must maintain the seriousness of the regulation control system; anyone can have a power beyond the regulation control system.

Process control of regulation control system is to correct the implementation of the system on the basis of the evaluation. Correction of deviation means to inspect and verify the potential disadvantages, in order to identify differences, and remedy the fault to minimize impact of the disadvantages. Correction of deviation can be divided into two kinds depending upon the different situations:

(1) Can the deviation be acceptable? If it can be accepted, the control body should not interfere and the performer continues as usual.
(2) Is the regulation control guideline in line with the actual? If it is consistent, thus deviation is originated from performers. Enterprises should further analyze the causes of deviation, formulate corrective measures, take corrective action, and intervene in performer's execution. If it is not consistent, thus deviation is originated from the regulation control guideline itself, and the control body should revise control guideline or make supplement.

There are two ways to get the corrective action by controller:

(1) The direct intervention. Controller directly and imperatively requires the performer to use the specified action to replace the original mode of operation.
(2) The indirect intervention. Controller develops and adheres to a set of effective incentive system, and through incentive systems correct the action of the performer automatically.

Article 29 Regulation control rewards and punishments:

Through the report and evaluation of the regulation control system, enterprise should determine the complete situation and degree of the regulation control objectives, in order to determine the management compensation, to give rewards.

Rewards and punishments are two of the most important tools in the regulation control systems. They play an important role in stimulating the enthusiasm and creativity of all managers and employees, implementing regulation control objectives, and carrying out layer upon layer organization's strategic objectives. Generally, to make effective rewards and punishments, following aspects are needed:

(1) Grasping the timing and extent of rewards and punishments accurately.
(2) Rewards and punishments should be practical to affect the employees' concerns effectively.
(3) There should be real systems to implement rewards and punishments, such as existing real and effective methods for evaluating and monitoring employee behaviors.
(4) Adopting different reward and punishment strategy according to different targets. Reward outstanding contribution generously and impose severe punishment

for those who cause huge losses. It can throw out a minnow to catch a whale through a variety of effective reward skills.

(5) Rewards should be democratic and be clearly distinct from punishments. Material rewards and spirit rewards should be connected.

3.7 Environments and Conditions of Regulation Control System

Article 30 The control environment is the basis of the enterprises to implement internal control. It dominates the awareness of internal control among entire staff and also affects the attitude and behavior of the staff when they implement control activities and assume their responsibilities. There are five parts involving organizational structure, development strategy, human resources, corporate culture and social responsibility.

Article 31 Organizational structure. The development strategy in an enterprise is based on the scientific organizational structure, which consists of governance structure and internal structure. If the governance structure exists in name only or the management lacks the ability to make decisions scientifically or to operate benignly, the company may finally fail. Meanwhile, without an appropriate allocation of responsibilities, internal departments may be overlapping or missing, which will certainly leads to inefficiency. In order to prevent and resolve such risks, there must be detailed requirements in the guidelines for organizational structure. For example, the guidelines should emphasize the importance of obeying national laws and regulations. It should also clarify the responsibilities and procedures of each department to make sure the process of decision-making, implementation and supervision is separated. Meanwhile, when it comes to an important event such as decision-making, transactions and appointments and dismissals or large sums of payments (commonly known as “three important events and one large sum”), the corresponding department should examine and approve the event together. Especially when a company owns subsidiaries, it should set up a matching system to manage its subsidiaries.

Article 32 Development strategy. Enterprise is the main body of the market economy. In order to develop continually, the key point for an enterprise is to set up suitable and flexible development strategy. During the survey, it is discovered that the lack of clear and proper development or the inadequate implementation will result in negative consequences. For example, an enterprise may develop blindly without comparative advantages and sufficient impetus. Or else, some enterprises may develop in an aggressive way that ignores the real condition of them, which finally leads to excessive expansion or even fail. It is also discovered that some enterprises change their development strategies too often that results in the huge waste of resources and finally fail to survive. Therefore, the guidelines for development strategy put forward corresponding solutions to these potential

problems such as clarifying the standards to develop, implement and evaluate a strategy.

Article 33 Human resources. Snapping up talents has become the linchpin for an enterprise to succeed in today's intense competition. It's undeniable that human resources are the intelligence treasure in an enterprise. The core competitiveness can be greatly enhanced if the human resources are properly allocated. However, if an enterprise lacks enough talents or just the opposite, has redundant staff, it is hard to realize its strategy. If the incentive system is imperfect and the key staff is under improper surveillance, it may lead to inefficiency or the loss of talents. Moreover, without reasonable talents withdrawal mechanism, it may bring lawsuits to an enterprise that will damage its reputation. In order to prevent and mitigate these crucial risks, the guidelines for human resources clarify the corresponding requirements such as to establish and improve talents withdrawal mechanism (involving resignation, dissolution of the labor contract, retirement and so on), to set up a remuneration system linked with the performance.

Article 34 Social responsibility. To grow continually, an enterprise has to take its social responsibilities. The guidelines for social responsibilities focus on the weak points including four parts. Firstly, it requires the enterprise to set up strict safe production management system, practices and contingency plans as well as responsibility tracing system. Secondly, the enterprise has to establish standards for production procedure in order to control and examine the quality of productions. Thirdly, the enterprise should attach importance to protecting environment and conserving resources in order to improve resources utilization efficiency. At last, the enterprise should safeguard the lawful rights and interests of staff.

Article 35 Corporate culture. Corporate culture is a general term for values, business philosophy and spirit of an enterprise that is accepted and respected by the whole staff, which is formed gradually during the course of production and operation. It is the spirit of an enterprise and it runs throughout the whole process. Moreover, it is the impetus for an enterprise to grow continually. In reality, some enterprises fail because of the serious problems in corporate culture. There should be corresponding requirements in the guidelines for corporate culture.

Article 36 Regulation control is the basis of other control systems. Compared to Budget Control, Evaluation Control and Incentive Control, the operation of regulation control system does not have a high requirement on the organization's management infrastructure and the environment. Whether new or mature enterprises, sunset or sunrise industry enterprises, small or large organizations, all of them have a regulation control system in operation. Regulation control system requires quite low standard on the management environment. However, it is commonly used by the majority of organizations and becomes an important part of management control because of low requirement on management infrastructure and the environment.

A key factor that the regulation control system can play a role in organization controls is that regulation control must be suitable for the organization's environment, which means external and internal environment of enterprises. The starting point of the regulation control system should be the organization's external environment because the regulation control system is determined by the external environment firstly and then the internal environment. That is the only way to ensure that the rule- based control system can be applicable to organization's internal and external environment and to guarantee that the regulation control system can play an effective role in the organization.

Chapter 4
Application Guidelines for Enterprise Management Control No. 2—Budget Control System

4.1 General Provisions

Article 1 These Guidelines have been formulated in accordance with the relevant laws and regulations, as well as the "Basic Standard for Enterprise Management Control" to strengthen budget control for corporations and other organizational units, achieve resource optimization, enhance management synergy effect and improve the efficiency and effectiveness of operations, The guidelines are intended to ensure the smooth and efficiency of budget control systems.

Article 2 "Budget control" in these guidelines refers to regulating the organization's goal and economic behavior processes by adopting budget plan, adjusting and correcting the deviation of management behavior and target, thereby to ensure the implementation of objectives, strategies, policies and plans. From the perspective of control, budget control includes budget planning, budget execution, budget variance analysis and deviation analysis.

As a mode for the management and control system, budget control system should include strategic planning, budgeting, budget control, budget evaluation, budget incentives, etc.

Article 3 In accordance with these application guidelines, an enterprise shall establish budget control system, set up objectives and principles, organizations and responsibilities, procedures and methods, to create environments and conditions for the budget control system.

Article 4 General managers of enterprise are responsible for the establishment and implementation results of the budget control system.

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4.2 Objectives and Principles of Budget Control System

Article 5 The objectives of budget control system include basic objectives and specific objectives.

Article 6 Basic objectives of budget control system are consistent with management control objectives, which is the pursuit of operation efficiency and effectiveness.

Article 7 The specific objective is to achieve the quantitative targets independently during the operation process based on budget control standards. The specific objectives of the budget control system are to:

(1) Ensure the realization of the strategic objectives of enterprises and the quantification and specification of strategic plan.
(2) Implement effective process control, and correct the deviation in the economic operation.
(3) Make clear responsibilities, powers and interests of managers.

Article 8 An enterprise shall focus, at a minimum, on the following risks in budget control, which are:

(1) The enterprise may operate without constrains or blindly in the absence of budgets or sound budgets.
(2) The enterprise may waste resources or fail to realize development strategies if budget objectives are unreasonable or if budgeting processes are illogical.
(3) The enterprise's budgeting management may become a mere formality as a result of non-rigid budgeting, ineffective execution and non-professional assessment.

Article 9 In essence, budget control systems is a part of comprehensive budget management system, in other words, the system belongs to integrated management control system that is based on the budgets including multi-dimensional processes and all staffs. These systems also possess comprehensive control and binding force of an enterprise's overall business activities and departments. The following three principles are helpful to form a better understanding of the "comprehensive" nature of budget control system.

(1) Comprehensive Coverage Principle

Budget control should cover the entire company, which includes the headquarters, divisions and related functional departments and the associates, as well as associates' non-business units and their functional departments. In practice, many enterprises mainly focus on expense budget and capital budget, which are only temporary solutions. But the comprehensive budget is a consolidated summary of various units' functional budgets, such as sales budget, procurement budget, capital budget, financial budget, etc. usually, the finance department is the key to budget management, but in fact, all business activities are involved in comprehensive budget, including marketing, production, procurement, research and development

and financial activities, etc. In order to conduct business activities effectively, enterprises need to prepare financial budget along with operating budget and capital budget.

(2) Whole Process Control Principle

On the basis of budget, control activities run through the whole course of business activities, and can be classified as beforehand control, intermediate control and afterwards control. Beforehand control consists of setting budget objective and budget planning; intermediate control involves the enforcement of budget; and afterwards control depends on evaluation of budget. The control activities mentioned above form a complete budget control cycle. A number of enterprises attach great importance to budget planning, but take little notice of intermediate control, they neither implement the planning positively, nor monitor it effectively, let along perform systematic analysis. Some of other enterprises completely ignore afterwards control. Their appraisal mechanism, which reveals a poor combination of budget implementation and evaluation, is no budget at all.

(3) All-staff Participation Principle

The design and operation of budget control system is a complicated and systematic project, which must be highly valued by top management, meanwhile, the whole staff should be involved. When implementing budget control, the overall budget objective has to be decomposed and distributed to departments respectively. And the staffs who work in those departments must form a clear understanding of their targets and tasks. In order to achieve the objective, joint efforts should be made by all members from top to bottom. However, if everyone acts in his own way without cooperation, then the objective is hard to achieve, and consequently, enterprise value will be undermined.

4.3 Organizations and Responsibilities of Budget Control System

Article 10 The organizational system of budget control includes the budget management committee, budget management department and budget responsibility center.

Article 11 Budget management committee holds leadership position in the budget control system. Under the authority of the board of directors, they make decisions of important budget management. It is composed of chairman or general manager as the director of committee member, along with heads of related departments, such as the supply vice general manager, sales vice general manager, production vice general manager, finance vice general manager, personnel vice general manager, etc. For enterprise budget management, budget management committee is the highest administrative institution.

The budget management committee is obliged to:

(1) Formulate budget management policies, regulations, institutions and other relevant documents;
(2) Propose annual budget general objective, general guidelines and basic preparation requirements and submit these documents to the board of directors for approval;
(3) Review the company's capital investment and the project budget;
(4) Review the drafted budget and overall budget prepared by each department, put forward improvement suggestions, and submit to the board for approval;
(5) Find out if there are conflicts between departments in budget preparation, execution process, and coordinate it if necessary;
(6) Propose improvements on budget organization, planning, control;
(7) Submit the checked budget to the board of directors and issue a formal budget;
(8) Accept the regular budget reports, compare with actual, and make recommendations for improvement after careful analysis and research;
(9) Consider and make decisions on the budget amendment on request of actual needs;
(10) Mediate or arbitrate the conflicts in the budget management process;
(11) Consider budget incentives and programs proposed by the working group and submit to the board directors for approval.

Article 12 Budget management department is responsible for dealing with daily affairs related to budget department.

The budget management department is obliged to following:

(1) Convey the preparation of the budget policies, procedures. Give specific guidance to subsidiary, branch, department on the preparation of the draft budget;
(2) According to the budget planning guidelines, conduct a preliminary examination, coordination and balance for the draft budget prepared by subsidiary, branch, department. Prepare the group's draft budget after summary and submit to the budget management committee for approval;
(3) In the process of budget implementation, monitor and control the budget performance of the branches and departments;
(4) Issue the corresponding budget execution reports and budget variance analysis reports timely after each phase of budget execution and submit to the budget committee for consideration;
(5) In special cases, propose budget amendment proposals to the budget committee;
(6) Assist the budget management committee to coordinate and deal with some problems in the process of budget implementation.

Article 13 Budget responsibility center, based on enterprise's organizational structure and created in line with the principle of high efficiency, economy, power and responsibility clear, is the main budget responsibility department. It's composed of the investment center, profit center and cost center. Each responsibility center is

an organizational unit led by a manager responsible for the behavior of the center. The responsibility budget center is obliged to following:

(1) Each responsibility center is the execution organization of budget, that is, the main body of budget responsibility implementation. It is an organization that has certain permissions and bears the corresponding economic responsibility of internal unit;
(2) Involve in the preparation of responsibility budget;
(3) Organize the budget implementation of each center. Without approval, it must not change the budget;
(4) Organize operating activities, investing activities and financing activities in strict accordance with the budget;
(5) Develop specific programs and measures for budget implementation;
(6) Regularly or irregularly obtain feedback for budget implementation, truthfully report to the superior on budget implementation;
(7) Report in a written form in case of any required adjustment as per guidelines.

4.4 Categories and Contents of Budget Control System

Article 14 Budget control system has many kinds of classification. From the perspective of content, comprehensive budget system can be classified into different categories according to various standards, as mentioned below:

(1) In view of budget hierarchy, the system includes enterprise group budget, subsidiary or business unit budget, department budget and project budget, etc. Budget hierarchy is corresponding to the organization hierarchy. In an enterprise group, the strategic objective is frequently decomposed to top-down along with the organization hierarchy, including enterprise group objective, subsidiary or business unit objective, department objective and project objective. Whereas, the order of preparing budget is often bottom-up, first project and department budget then subsidiary or business unit budget and finally enterprise group budget.
(2) From the perspective of budget content, the budget system includes operating budget, capital budget and financial budget, etc. Operating budget also called business budget, and reflects the basic production and operating activities which are directly related to day-to-day business, namely sales budget, procurement budget, production budget and administrative expense budget. While, capital budget or special decision-making budget applies to the occasional and one-time business in the fields of investment and finance, such as fixed assets purchasing, expanding, reconstructing and updating and relevant fund raising. In terms of value, financial budget mirrors the overall outcome of decision-making and business. It refers to all kinds of budgets concerning financial position, operating achievements and cash flows. Hence, financial budget is also called general budget, for instance, budget balance sheet, budget income statement and budget cash flow statement, etc.

(3) From the viewpoint of traditional budget responsibility, the budget can be sorted into four budget centers, namely investment center, profit center, cost center and expense center. Each center has its own responsibility scope and business activities and thus leading to distinct budget responsibility and budget objective as well as content of budget planning. Cost center and expense center are only responsible for cost and expense and hence, their main purpose is to reduce cost and expense, for example, apart from preparing production budget, the production department has to prepare cost budget as well. Profit center is in charge of both revenue and profit targets, as a result, it needs to prepare both operating budget and profit budget. Similarly, investment center has to take into account of profit targets along with return on investment, which consequently should prepare operating budget, capital budget and financial budget as well.

(4) Based on the time period, the budget can be classified as period budget and project budget. Period budget is used to direct and coordinate production and operation activities. In light of length of time, it falls into three spectrums, namely long-term, interim and short-term budget. As a rule of thumb, long-term budget helps to indicate directions and draw up long-term plans of strategic significance with estimation. Operating and financial budgets generally cover a period of one year. The short-term budgets are prepared for periods less than a year, which are more concrete and precise, such as quarterly budget and monthly budget. Whereas, project budget deals with future action towards special events, which is unconstrained by hierarchy and time, such as merger budget and new product developing budget.

Article 15 As a mode of management and control system, budget control system includes setting of objective, budget planning, enforcement and evaluation.

Article 16 Setting of budget objective. Strategic planning is the starting point of management control system, and the setting of budget objective is the beginning of the budget control. Thus, the setting of budget objective is the starting point of budget control system as well as the fundamental basis of budget planning. The strategic planning is based on strategic objective and strategic programming, meanwhile, the setting of budget objective is in accordance with strategic planning. In light of organization hierarchy, budget objectives can be divided into general objective and hierarchical objective. On the basis of strategic objective, general objective is a concrete reflection of strategic planning and dominates the budget system. Strategic planning varies according to different strategic orientations, which in turn leads to distinct budget objectives.

Meanwhile, the setting of general budget objective is based on both sides, that is, external environment and internal resources. On one hand, competitors restrain the objective. On the other hand, resources limit it. In light of function, general budget objective can be viewed as the connection between enterprise and its external environment, which defines development directions and level of competitiveness. At the same time, it regulates the structure of resource allocation. Moreover, it provides a benchmark for clarifying hierarchical objective. As the refinement and foundation of general budget objective, hierarchical objective imposes direct incentive and put

restraint on related departments and principals, which in turn largely depends upon the feasibility of general budget objective and the effectiveness of mechanism of incentive and constraint. More importantly, it decides whether the enterprise will survive or not. Consequently, when carrying out budget control, the managers should monitor the complexity of budget objective carefully. It has been proved by empirical study that, as a rule of thumb, 'rigid and realizable budget' will bring about the best outcome, and only in this way could motivation and control be performed effectively.

Article 17 Budget planning. Budget planning refers to the process of setting general budget objective and decomposing it into hierarchical objectives for implementation. In other words, it is the process of ascertaining budget control standards. As an essential part of budget control system, the quality of budget planning has a direct impact on the outcome of budget implementation as well as the performance evaluation of implementers.

Budget planning is a course of participation and coordination. Participation allows implementers to comment on the planning rather than merely forced to do so. On one side, it largely reduces the degree of information asymmetry between management and implementers. On the other side, it arouses participants' sense of responsibility and creativity. In this way, implementers acknowledge organizational goals and greater goal congruence can be achieved. Coordination, in terms of budget planning refers to the process of negotiation and consultation before submitting the budget to superior for approval. The preparation of budget planning has to experience dozens of iterations, both top-down and bottom-up. By this means, the final budget will not only satisfy overall interests but also enhance departmental coordination, as well as conform to reality. Thereby, it may mitigate the risk of unrealistic decisions made by top management. Budget planning involves each department and individual, which in turn needs full participation and support.

Article 18 Enforcement of budget. Enforcement of budget includes implementing the budget, monitoring the process of implementation and analyzing the outcome. Enforcement of budget is the key to budget objective. It is at the heart of budget control system. Above all, the effective enforcement of budget relies on budget constraint mechanism. On one hand, the concrete responsibility performance standards play key role in the enforcement of responsibility budgets. When setting standards, the enterprise should not only focus on controllability, but also consider the limitation of striving for competitive advantages. On the other hand, determinants of the ultimate outcome of budget control are whether all kinds of economic resources are given full play, especially employees' initiative, creativity and sense of responsibility. In addition, budget coordination, budget analysis, budget adjustment, budget supervision and arbitration are essential procedures and pledge to the effective enforcement of budget. In the process of budget implementation, internal report is an important control mode. The control to the above procedures is dynamic, which focuses on regular monitoring and adjusting implementation effect and its formation, that is, after getting information by means of operation accounting and field observations, it compares output variables of controlled object with control standards in a timely manner, puts forward measures to correct deviations, and

constantly eliminates deviations between implementation effect and the established standards. All these activities need a feedback carrier, an internal report, which is also a vital control method.

Internal report is the feedback carrier of budget control and the reverse process of budget control implementation. It presents the process and result of budget control to management of all levels. Consequently, it is beneficial to perform intermediate and afterwards control as well as conduct responsibility analysis and performance appraisal. At the meantime, internal report contributes to maintain and control enterprise's assets and profits, and also helps to achieve optimal utilization of resources and management synergy.

During the process of budget control implementation, the actual process and effectiveness ranging from different levels of individuals and units to the whole enterprise, are clearly reflected in respective internal responsibility reports by means of bottom-up summary. As mentioned above, the report facilitates the control process by comparing actual performance with relevant established budget and taking corrective actions. It directs and coordinates business activities and units to achieve stated targets.

Article 19 Evaluation of budget. Evaluation of budget consists of two parts, which are budget assessment and budget incentive. Budget assessment is to evaluate the performance of each class of department or business unit. It is an effective means of incentive and constraint conducted by management. The assessment has two implications. First of all, it focuses on overall budget control system, that is, the evaluation of operating performance. Moreover, it provides a valid way of improving and optimizing the system. Secondly, the assessment is an essential measure to budget incentive and constraint in that, it appraises the performance of individuals who carry out the budget. It runs through the process of budget implementation. As a consequence, the assessment is not only dynamic and comprehensive but also providing a link within the system. This assessment process has the following benefits:

(1) With reference to budget responsibility objective, forming a full understanding of the actual performance and providing ideas for coordination of contradictions and correction of errors and deviations;
(2) Determining the responsibility as well as contribution of each unit and individual for rewards and penalties;
(3) Offering valuable experience to the next budget objective and a fundamental basis and pledge to improve the effectiveness of following budget control.

Budget control system should be combined with performance management, as this incentive mechanism is crucial to the effective running of budget control system. Setting of budget standards, enforcement of budget as well as timely and accurate feedback, not to mention evaluation of budget, all those activities largely depend upon incentive mechanism. Consequently, incentive mechanism runs through the whole course of budget control system and incentive is an integral part of the system. The purpose of incentive is to create initiative and a sense of achievement. At the same time, it should observe the rules of material benefits, fairness, differences and

diversity. There are generally two types of incentive measures, namely financial incentives (such as bonus) and non-financial incentives (such as promotion and delegation of authority). The establishments of incentive standards may be on the basis of either internal system of rewards and penalties (predictable and fixed) or senior management's subjective judgment (rely on incentive provider's subjective judgment and may reflect environmental change). Incentives can be performed on both individual and group.

4.5 Procedures and Methods of Budget Control System

Article 20 As a pattern of management control system, budget control system should include setting of budget objective, budget planning (including budget planning, budget approval and budget notification), enforcement of budget (including control of budget implementation, budget analysis and budget adjustment) and evaluation of budget (including budget evaluation and budget incentive).

Article 21 Methods of budget objectives setting. There are three methods for the setting of budget objectives as follows:

(1) Decomposition of budget objective. In view of content, key success factors (KSFs) of realizing strategy should be refined and incorporated in the strategic planning, which therefore has a close relationship with enterprise's overall strategic objective and strategic programming. Those KSFs comprise the control objective of enterprise's business activities which contain both financial and non-financial factors. On the one side, financial performance is a kind of comprehensive afterwards reflection which has lagging and short-term effect. On the other side, more often, non-financial activities are key factors for improving financial performance, which has been proved in practice. By means of analyzing the basic requirements of business activities regarding strategic objective and strategic programming, strategic planning and KSFs are clarified, which in turn produces more detailed control objectives.
(2) Financial objective is the ultimate goal of the enterprise, which is closely related to organizational objective. Consequently, it should reflect shareholders' increased value. In essence, all capital has its relevant cost and shareholders' value can only be improved by obtaining revenue which is higher than its cost of capital. With the help of Economic Value Added (EVA), enterprise is able to properly measure the increase of shareholder wealth. As a consequence, EVA should be the key indicator for evaluating value creation as well as in the indicator system of budget control. Thus, the budget control indicators can be distinguished into five aspects, which are value-creation, profitability, growth, operation ability and liquidity respectively. By regarding EVA as the core indicator, the indicator system may be decomposed layer-by-layer accordingly, and connections should be made between the system and the above five ability indicators. With reference to Performance Evaluation System for Chinese

State-owned Capital, the fundamental choice of setting indicator system of budget control can be established. The so-called fundamental choice only provides the scope which is the basis of forming indicator system of budget control. Actually, based on diverse background, enterprise may choose distinct fundamental choice indicators in its own way. Moreover, it may also design some special indicators to reflect the characteristics of its organization background. However, the amount of budget control indicators can not be too many or too few in that, too many may bring about 'information redundancy' and do not conform to cost-effective principle, which may even result in ambiguous control objectives; too few makes it unable to completely reflect the content needed to be controlled and attend to one thing and lose another.

(3) During the process of setting budget control standards, the following four facets are noteworthy:

First of all, historical and current data should be considered together when making vertical analysis. The so-called historical data is the actual result of each performance evaluation indicator based on respective periods, which fully reflects the characteristics of organization background.

Secondly, by means of horizontal comparison, benchmarking should be made with enterprises of the same industry or stereotype. Serving as the industry standards of evaluating performance, the value of specific indicator mirrors the external environment and technical features of enterprise. On the basis of industry standards, enterprises take into account of key organization background variables, such as external environment and technical features, when formulating prediction standards. But the problem is how to get access to historical data of industry. Gleaned from years of management consultancy, the following approaches can be applied to obtain the data: manual of performance evaluation standards of the owned-country capital (which is revised by the ministry of finance yearly and published accordingly); the data publicly disclosed by quoted company (such as the operating performance ranking list of quoted company announced by the media or management consulting firms); the statistic data of industry associations (a variety of industry associations frequently carry out statistic analysis to enterprises' operating performance); and the official statistical data (including statistic yearbook).

Thirdly, in order to perform strategic planning, KSFs and its logical relationship with strategic objectives should be clarified. Strategic planning and organization background are the premise and basis of the setting of budget control standards. During the process of strategic planning, the enterprise should take into account of not only its external environment but also the resources and abilities that can be employed.

Fourthly, other organization background variables, especially the influence of external environment and organizational structure, also need to be considered, thereby, the factors regarding controllable and non-controllable can be distinguished. The time of setting strategic planning may be not the same as that of setting budget control standards, while the organizational background is changing rapidly. As a consequence, when setting budget control standards in light of specific year, in

addition to strategic planning, the changing of organizational background should also be regarded, such as conducting market predictions.

Article 22 Methods of Budget planning. A variety of methods can be adopted during the process of budget planning, such as fixed budgets and flexible budgets which are based on quantitative features of business; incremental budgets and zero-based budgets (ZBB) which are based on different starting point of budget planning; regular budgets and rolling budgets which are based on different time period. Each type of budget planning has its own pros and cons; accordingly, while choosing budget planning methods, enterprise should attach great importance to application conditions and scope of the methods.

Article 23 Methods of budget implementation. The control of budget implementation can be divided into four parts: budget authorization control, budget approval control, budget adjustment control and budget analysis and feedback control.

(1) Budget authorization control. Budget authorization control means that before implementing budgets, the related departments and staff must be authorized by certain approval procedures. By means of authorization control which belongs to beforehand control, the incorrect, improper and illegal economic behavior may be effectively reduced before happening. As an important internal control approach, it is necessary for budget control to set authorization items, permissions and amounts in advance. Budget authorization can be further split into budgets distribution, authorization within budgets and off-budget authorization. Budgets distribution refers to defining the decision-making power within the hierarchy during the process of budget management. In accordance with governance principles of separation of powers, decision making power of budget management should be split into three parts, they are decision-making, implementation and supervision. The board of directors and its affiliated budget management committee are the budget decision-making body. Management level including subsidiaries and divisions are the budget implementation body. Board of supervisors, office of budget management committee, financial department and internal audit department are the budget supervision body. Before carrying out budget management, the power of budget decision-making, budget implementation and budget supervision should be set and clarified in advance. Authorization within budgets means that the budget implementing departments and principals authorize normal business activities within scope of authority according to budget control standards. It stresses that matters within scope of budgets are decided by chief principal of the budget responsible division without asking superior for approval. Off-budgets authorization refers to authorization under contingent situation budgeting and can also be called as contingency budgeting which emphases those business activities or items beyond range of budgets must be managed by way of budget adjustment or budget super addition and be approved by an authorized person.
(2) Budget approval control. After the business activities have taken place, budget approval control performs intermediate control to business related reimbursement

and appropriation by means of accounting information system. In order to achieve this, first of all, budgets should be combined with accounting and direct correspondence should be established between them. Thus the budget control system should be software-based in informatization respect. By setting structural and systematic definitions, the correspondence between budget control items and accounting subjects can be clear and precise. During the process of budget implementation, when entering and saving accounting documents, instead of the accounting system we should first log-in budget control system which will automatically check whether expense budgets and capital budgets exceed relevant yearly and monthly budget control standards, and at the meantime, record expense and capital expenditure respectively, and in turn conduct control alert and balance control. If one specific item is within budgets and does not exceed the red line, then it will enter into the accounting system; If it is within budgets but exceeds the red line, it can still enter into accounting system, meanwhile, the system will alarm related business department to control current expense and capital expenditure; If the items are within budgets but the amount exceeds budgets or belongs to off-budget item, they all need to go through into budget adjustment procedures. Consequently, it follows that budget approval control performs sound real-time and process control to business activities, reimbursement and capital appropriation.

(3) Budget adjustment control. Budget adjustment control means that when the enterprise experiences changes both internally and externally, a large deviation has emerged between budget and reality and thus the original budget will not apply to budget revision. Based on theory, in order to maintain the seriousness of budget, when implemented, it should not be changed easily. However, budget is not rigid or invariable. If significant changes have taken place after budget implementation, then budget adjustment should be taken into consideration, which embodies the flexibility of budget. The key point is that adjusting budgets should satisfy certain preconditions and follow approval procedures. In line with whether the adjustment has impact on overall budget control objectives, it can be divided into budget adjustment within objectives and off-objectives budget adjustment. Each type of budget adjustment has its own preconditions and approval procedures, thus enterprise should choose a suitable type as required. As a rule of thumb, when the premise of budget control objective has changed greatly, such as marketing environment and internal resources, off-objective budget adjustment should be performed. Generally, budget adjustment experiences three major procedures, namely application, examination and approval. As an unusual matter, budget adjustment involves the all aspect, consequently, its authority of examination and approval should be highly centralized. Off-objective budget adjustment has to be approved by budget management committee, while budget adjustment within objective should be approved by person or department that has relevant privileges.

(4) Budget analysis and feedback control. In the process of budget implementation, budget responsibility unit should check timely, track the implementation of the budget and generate a feedback report of budget variance analysis. Regularly

submit the last month's budget variance analysis report to upper manager. Finally the budget specific department forms a budget difference analysis feedback report and posts to the budget committee to provide information for the budget management committee to have dynamic control of the entire budget execution.

Article 24 Evaluation of budgets. The budget evaluation has two meanings: one is the evaluation of budget control system, namely evaluate the enterprise operating performance; the second is the assessment and evaluation of budget enforcer. Budget assessment is a necessary measure to play the role of budget constraints and incentive. In order to achieve budget control objectives, the occurrence of each transaction should be connected with related budget items. Therefore, the following measures may be taken:

(1) Set up scientific budget analysis procedures and approaches. Serving capital utilization as the analyzing objective, make full use of the DuPont System to analyze budget implementation. Besides using horizontal and vertical analysis to find the deviation between actual result and budgets, factor and trend analysis should also be performed in relation to the deviation of significant matters.
(2) Set up post responsibility system of budget analysis and formulate systematism, standardization and tabulated budget analyzing systems. Above all, the specifically formulated budget analyzing system defines the responsibility of each department, section and individual, meanwhile, it appoints specialized staff to perform analysis. Next, budget analysis should be performed periodically. While analysis and evaluation are efficient ways to see how the budget is performing, and accordingly, the adjustment of next budget figures and incentives can be set. Finally, in order to maintain high operability, a full set of budget analysis forms should be designed.
(3) Set up budget control software system. With the help of this, budget planning and analysis can be embedded into software program, which in turn improves efficiency of budget analysis and avoid the failures lead by human factors as well as strengthen the rigidity of budget control.
(4) Build budget system of rewards and penalties. This is for the purpose of avoiding budget implementation to become a mere formality, strengthening the sense of responsibility of related budget departments and individuals and insuring the realization of budget objectives.

Furthermore, methods of budget Incentive are as follows:

(1) Executive Compensation. Enterprises should combine budget execution results, management performance and incentive compensation mechanism together, reward those who comply with budget standards and performance; while punish those who does not meet the required level of standards and performance.
(2) Revenue-sharing program. The "revenue-sharing program" refers to according to the pre-determined productivity and profitability improved formula, employees and the company share financial benefit. Revenue-sharing programs enable employees to share the benefits caused by efficient improvements of organization

or department. These programs encourage teamwork and reward for their total contribution to the organization. Some common examples of profit share programs include: profit sharing schemes, collective benefits and sharing plan, risk benefit balance plan and employee shareholding plan, etc.

(3) Non-financial means. In addition to financial incentive, enterprises should pay attention to the use of non-financial incentives, for example giving appropriate autonomy to subordinate departments and their staff, so that enterprise employees can participate in the managerial decision-making. By participating in preparing budget, enterprises can enhance their sense of responsibility and satisfaction to finish the work well. The implementation of non-monetary incentives program can improve employee's self-esteem. Through publicity and education, organizing seminars, exchange of ideas such ideological ways, enterprises can stimulate personal sense of professionalism, responsibility, corporate ownership, etc. By promotion, an enterprise shall conduct appropriate working arrangements such as expand the authority and the scope of work to motivate.

4.6 Environments and Conditions of Budget Control System

Article 25 Control environment involves various aspects, namely corporate strategy, organization structure, responsibility center, human resource and corporate culture, etc. Environment of budget control system should include a defined strategy (including strategic objectives, strategic programming and strategic planning), certain human resource quality and a sound corporate culture. Specially, proper organization structure and responsibility center are indispensable. The organization structure is crucial to budget control system.

Article 26 Mechanism and organization of budget control. The design of budget control system involves a series of steps, ranging from enterprise objective and strategy to budget objective, planning, implementation and analysis, etc. The realization of targets in each link is rest upon budget control mechanism, which in turn forms the basis of budget control system.

The organizational system of budget control lies at the heart of budget control mechanism. Whether the budget control mechanism is scientifically designed or not, will have a great impact on the functions of budget control. In China, the organizational system is usually divided into three levels, including budget management committee, the standing body of budget committee (financial department) and competent departments of budget. In theory, this kind of organizational structure is beneficial to the realization of budget control system. But in practice, the following points are noteworthy:

(1) Strengthen the functions of budget management committee and highlight its importance to budget control system. In practice, the budget committee in some enterprises performs practically no function and does not play its due role. In

order to avoid this, the functions of budget committee must be definite and complete, for example, major issues including the design of budget objective, standard and evaluation should be decided by the budget committee. Moreover, the committee should hold meetings on regular basis and form institutionalized and standardized management. Meanwhile, budget committee has to maintain a standing body with responsibility of carrying out resolutions.

Budget management committee lies at the heart of organization system. Acting as the agent of board of directors, it handles and decides matters of significant importance. Principal of the committee is the chairman or chief executive director, and other members are consisted of people in charge of relevant departments, such as the vice manager of sales department, production department and financial department, etc. As with budget management, committee of budget management is the top governing body.

(2) Improve the status of financial department in budget control system, meanwhile, great importance should be attached to it when making budget planning, control and analysis. In practice, there are various ways of setting the standing body of budget management. While, we hold the view that setting financial department as the standing body is more scientific. Nowadays, owing to the financial-oriented management, the enterprise budget will also be centered in financial budget. Naturally, as the standing body of budget committee, the terms of reference of financial department enlarge greatly. At the same time, budget committee should make it clear that financial department is its executing body and in charge of comprehensive budget planning, analysis and control.

(3) Establish and perfect hierarchical budget control system. To some extent, internal control system is also a kind of authorization system. Thus, besides setting primary budgets, to some major departments and projects, more detailed secondary budgets should be established. Set an integrated budget control system that consists of a set of procedures, including budget planning, implementation, control and analysis, and make each budget-related department to perform its own functions as well as setting the relationship which is equal with responsibility, authority and benefit.

Article 27 Setting of responsibility center. Setting of responsibility center is a basic requirement of budget control. The responsibility center refers to a unit that can control cost, revenue and capital appropriation within certain limits. It is a combination of responsibility, authority and benefit. In order to better monitor and conduct business activities, enterprise should be split into several progressive responsibility centers, which are closely related to organizational structure. In hierarchical management, according to terms of reference, responsibility centers can be classified as investment center, profit center and cost center. The classification of responsibility centers is essential to budget control system in that, the centers are in charge of implementing budgets. During this process, the following points are noteworthy:

(1) The classification should have clear hierarchy. In order to effectively control business activities, enterprise should be divided into several responsibility

centers. Each center programs and controls a part of business activities and accountable to its performance.

(2) Balance rights and responsibility. Responsibility centers assume their liabilities according to respective rights of operating decision-making, which mean that decision rights bring about corresponding economic responsibilities. As a result, when setting responsibility center, economic responsibilities must be in line with decision rights, which will prevent power abuse.
(3) Production and operating performances should be clearly defined. In other words, responsibility must be specific, defined and measurable.

Fourthly, the classification of responsibility centers should be combined with business process reengineering.

Article 28 Basis of budget control. Besides environmental aspect, in order to run budget control system effectively, the following aspects should also be taken into consideration:

(1) Decentralized management. Budget is directly linked to organization structure. According to the degree of power concentration, organization can be divided into centralized and decentralized organizations. In a centralized organization, decision rights are centralized on top management whose decisions, orders and instructions must be followed by subordinates. While in a decentralized organization, top management delegates part of authority to lower levels, which enables them to control some of the resources and solve a few problems independently. Organization structure plays a key role in budget participation. In a decentralized organization, if there is a high level of budget participation, manager will feel that his involvement is the key to the budget, and then a strong sense of achievement arises. On the contrary, the centralized organization stresses less on budget participation. Consequently, the decentralized management that encourages full involvement during the process of budget planning enhances the feasibility and reliability of budget indicators, which is beneficial to effective allocation of resources. Moreover, it arouses the self-awareness of employees when implementing budgets, which in turn improves efficiency. Meanwhile, it helps to exchange information among departments and between staff and enterprise. In addition, delegating daily operating authority to relevant responsibility center enables the centers to act according to actual circumstances in a timely fashion and fully mobilizes employees' initiatives and creativity.
(2) Business process reengineering (BPR). BPR involves a fundamental rethinking and redesigning of business processes, organization structures and use of technology, to achieve "breakthroughs" in business competitiveness, such as cost, quality, service and speed. During the process of budget control, ranging from budget planning, enforcement of budget to evaluation of budget, a series of stages should be set up, and among them is BPR. With the development of enterprise, certain problems might emerge, they are: disjunction of organizational performance and strategy, strategic programming lacks support of organization; ambiguous positioning of holding groups and parent-subsidiary

relationships, the contradictions between centralization and decentralization are gradually highlighted, whilst, standardization and flexibility are difficult to coordinate; a sheer size of organization, arbitrarily setting of departments, unsmooth information channels, loss of information and information distortion, etc. An optimistic outcome can not be attained if it is performed under such circumstances. The basic environment of budget control system is organizational setup. Thus, when enterprises implement the system, organizational structure should be clear and definite. But this does not mean that only when organizational structure is clear and definite, can budget control system be performed. In fact, there are interactions between budget control and organizational process, they complement each other. In many cases, they are inseparable. In order to implement budget control, certain issues must be clarified, namely responsibility centers (including investment center, profit center and cost center), management duty (such as business items, time, amount of capital, etc.), information collection and feedback report. All that request enterprises set up specific business process, framework, hierarchy of management and control points. Business process reengineering should focus on customer and strategy. Based on optimizing system process, by performing activity analysis it establishes activity center, whilst by performing process analysis it establishes process center and finally forms a three-tier structure, that is tactical level, managerial level and operational level.

(3) Management information system (MIS). MIS refers to the system that provides information to all levels of management and staff inside and outside of organization and which is also crucial to management control. Without a favorable MIS, the ideal results of budget control cannot be achieved. In an MIS, the information includes budget information, accounting information, statistic information and business information, etc. In view of budget control, the information quality of accounting, statistic and business play a key role in performing budget control system. As a consequence, MIS must meet the following requirements:

① Information should satisfy the need of budget control relevance, which means that all kinds of information including financial, statistic and business data are serving for budget control.

② Time of information should cater to the timeliness of budget control. Budget control is a process-control in nature; as a result, accounting related information and report should be as promptly as possible. In order to achieve this, traditional stereotype of post-accounting needs to be changed, moreover, updated information management technique needs to be utilized, such as Enterprise Resource Planning (ERP).

③ Information technology should conform to actual of budget control. The truthfulness of information is the key to control process. Many reasons may lead to false information. From the professional view of point, misappropriation of accounting technique is a main point. Budget control system requires a scientific and reliable information accounting technique, which includes financial accounting technique and other business accounting technique.

Article 29 Application scope of budget control system. Same as system control, budget control system can be applied to all kinds of organizations and enterprises. Whereas, it is difficult to set and implement budget control for enterprises which management basis are relatively poor. It is easier to carry out budget control system in company with good basis of efficient and effective management. But if company overemphasizes budget control, the subjective initiatives might be constrained.

Chapter 5
Application Guidelines for Enterprise Management Control No. 3—Evaluation Control System

5.1 General Provisions

Article 1 These Guidelines have been formulated in accordance with the relevant laws and regulations, as well as the "Basic Standard for Enterprise Management Control" to standardize the management control practices of enterprises, improve the efficiency and effect of the operation management activities, and ensure the realization of organizational strategic objectives, which is in order to strengthen the management control system construction of enterprises.

Article 2 "Evaluation control" in these guidelines refers to various members in the enterprise that is mainly consisted of managers, who apply specific indexes and standards, adopt reasonable procedures and methods, make an authentic, objective, and fairly comprehensive judgment on the process and results of organizing production and operating activities, so as to standardize the economic targets and behaviors of managers and employees at all levels, and finally realize organizational strategic objectives and planning.

Article 3 In accordance with these guidelines and in the view of the design and operation of the status of management control system, an enterprise should establish detailed principles and procedures for evaluation by specifying objectives, elements, contents and methods; defining responsibilities of the relevant organizations; and building up an Evaluation Control System in line with right environments and conditions.

Article 4 The principals of an enterprise should be responsible for establishing rational guidelines and making sure that it will be implemented effectively.

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5.2 Objectives and Principles of Evaluation Control System

Article 5 With the aim of achieving operational efficiency and effectiveness, the objective of the evaluation control system should be consistent with management control objectives.

Article 6 The basic objective of evaluation control system is to improve the efficiency and effectiveness of management activities, and realize the organizational strategic objective.

Article 7 The specific objective of evaluation control system is to ensure the congruence of different organizational and personal objectives, which includes:

(1) Evaluating the strategic objective. First of all, it is important to predict the developing tendency of the enterprise's strategies in the future. According to evaluating, predicting and judging the future developing tendency of the enterprise's operating activities, the managers can obtain related information that is favorable for the strategic adjustment, so that they can plan the future of the enterprise's objective preferably.
(2) Evaluating the operating performance of enterprises. The main task of this objective is to control the differences between the actual performance and the evaluation objective. According to the evaluation, it is feasible to provide the control-based information that is related to the realization of the strategic objective, so as to identify the off-targets phenomena, analyze the subjective and objective reasons, and adopt corrective actions to ensure the final realization of the strategic objective.
(3) Evaluating the performance of managers. Managers' behaviors are crucial for ensuring the organizational strategic objective can be realized. It is necessary to resolve the strategic objective into evaluation objectives, and carry it out towards the corresponding department or personnel in charge. The evaluation is helpful to measuring the operational performance of the responsible departments and their employees.
(4) Encouraging the managers' operation management behaviors. It is effective to carry out corresponding rewards and punishments towards the managers based on the evaluation results. On one hand, it motivates the managers to actively adopt corrective actions and induce the occurrence of the expected behaviors; on the other hand, it leads the managers to adopt effective measures to compensate for the gaps and to change the backward situations.

Article 8 Appropriately handling the relationship between the performance evaluation of the departments and the performance evaluation of the managers is significant to the effective implementation of evaluation control system. It is necessary to distinguish departments' performance and managers' performance during the performance evaluation in view of uncontrollable variables for managers. The uncontrollable variables of managers are referred to the occurrence and change the characteristics of the variables which cannot be affected and predicted.

Therefore, an enterprise should focus, at a minimum, on the following risks in evaluation control system:

(1) The enterprise may be operated without constraints or blindly in the absence of regulations and budgets or sound regulations and budgets.
(2) The enterprise may be operated inefficiently or failed to realize the development of the strategic objective if evaluation objectives are not reasonable or evaluation process is not operational.
(3) The enterprise's evaluation control may become a mere formality as a result of lacking incentives or implementing incentives irrationally.

Article 9 During the procedure of establishing evaluation control system, the following basic principles should be complied with:

(1) Controllability principle. It needs to take the uncontrollable factors into consideration and avoid them as possible, so the evaluation can be limited in a controllable range of the departments or the managers during evaluating the performance of both the subordinated departments and the managers.
(2) Acceptability principle. It is necessary to communicate repeatedly with the persons who are evaluated during the process of clarifying the evaluation objectives, and to consider the rational opinions from those persons, so that the evaluation objectives can be accepted by the members of the organization.
(3) Contingency principle. The enterprise survives and develops in a certain background in common. Therefore, the selection of evaluation indexes, the setting of evaluation standards and the establishment of evaluation methods should adapt to different organizational backgrounds.
(4) Systematic principle. As an independent subsystem of the enterprise, the evaluation control system consists of strategic planning, evaluation indexes (indexes selection, indexes standards, and indexes calculation), evaluation procedures and methods, evaluation reports, rewards and punishments and other factors. The relation between different factors should be taken into the consideration in the design of evaluation control system.
(5) Cost-benefit principle. Comparing with the implementation and maintenance cost, a perfect evaluation control system, on the basis of management decisions, can provide greater benefits, which include the improvement of provided information, the minimum of costs and the maximum of profits.

5.3 Organizations and Responsibilities of Evaluation Control System

Article 10 To ensure that the organization performance evaluation is progressing and not stagnant, the organization should establish or specify specialized management institution to take charge of the performance evaluation. It is necessary to establish leading group or similar organizations inside the enterprise for performance evaluation,

which should include evaluation leading group, evaluation operation group and monitoring group of evaluation. It is also feasible for the human resource department to guide the performance evaluation according to the enterprise's conditions.

Article 11 Evaluation leading group. As a decision-making institution of internal performance evaluation, the performance evaluation leading group takes full charge of the guidance, the organization, the coordination and the audit of the internal performance evaluation. This group is directly led by organizational principals. Other senior managers are the members of the group, including the principals from the department of human resource management, the production management department, and the financial management department.

The specific responsibilities of performance evaluation leading group include:

(1) Formulating general objectives and policies of the internal performance evaluation based on the strategic objective and planning.
(2) Establishing evaluation control system to supervise and evaluate the implementation and the operations of the system.
(3) Organizing examination to report annual internal performance evaluation schemes and confirm the annual evaluation objectives of all responsible departments and persons in charge.
(4) Coordinating and solving the problems during the development and execution of performance evaluation programs, and arbitrating the conflicts among different departments during the evaluation control process.
(5) Submitting rewards and punishments schemes to the board of directors according to the results of internal performance evaluation.

Article 12 Evaluation operation group. The performance evaluation leading group office is a typical evaluation operation group, which is the daily management institution of the evaluation committee. It can also be established in human resource department.

The responsibilities of performance evaluation operation group (i.e. evaluation leading group office) include:

(1) Making full analysis and doing research on the internal and external environmental factors (e.g. market status during the evaluation period, the policies and regulations environment, and other relevant factors); submitting annual internal performance evaluation schemes to the leading group, in accordance with the general objectives and policies of the internal performance evaluation, which is drawn up by the performance evaluation leading group.
(2) Taking charge of coordinating and following the daily affairs of the internal performance evaluation, supervising the implementation process, reporting the implementation situation of strategic planning and its influence on the performance evaluation to the leading group regularly, then reporting great events in time.
(3) Organizing internal performance evaluation with the other departments (e.g. operation management departments and financial management departments, etc.). Forming internal performance evaluation reports and submitting them to the leading group.

Article 13 Monitoring group of evaluation. The supervision of evaluation control system is an assurance for the effective implementation of the evaluation control system, and also an important measure for identifying the defects of the system and improving the system continuously. Each enterprise and public institution should attach great importance to the supervision and check the evaluation control system.

Evaluation is a management behavior carried out by managers. Managers should take charge of the daily operation of management control system. Especially, the board of directors or the supreme administering authority should supervise and check the establishment and the effectiveness of implementation of a sound evaluation control system.

The enterprise should pay close attention to monitoring and checking the operation of evaluation control system. The specialized agencies or the specified professionals take charge of monitoring and checking the system operation, and ensure the effective operation of the evaluation control system. And the main responsibilities are as follows:

(1) Checking and evaluating the operation status of evaluation control system at all times.
(2) Preparing inspection reports and putting forward improvement suggestions on the existing defects of evaluation control system.
(3) Putting forward recommendations on the internal organization and personnel with obvious implementation effects of evaluation control system, and disposing opinions towards the internal institutions and personnel that damage the evaluation control system.

Article 14 In addition to the organizations above, the enterprise can invite intermediaries or relevant professionals to evaluate the right establishment and the effective implementation of evaluation control system. The intermediaries or relevant professionals that accept engagement should put forward a written report to the entrusting party which is aimed at the major defects discovered from evaluating the control system.

5.4 Ranges and Contents of Evaluation Control System

Article 15 The range of evaluation control system contains all the units of an enterprise, including all companies, all departments, all managers and even all employees in general. As a results-oriented control system, its core content of evaluation is to evaluate the realization of all objectives in an enterprise.

In order to evaluate rationally and efficiently, the range of evaluation control should be divided into small parts on the basis of enterprises' requirements. There are different methods with different definitions of evaluation subjects and objects. The evaluation subject is the behavior subject of implementing performance evaluation.

The evaluation object is a directive target of performance evaluation behavior. However, the internal evaluation subject and object vary from the control levels:

(1) From the perspective of the control levels of organizations, the evaluation control in an evaluation control system mainly includes three levels: from the group to the companies; from the strategic organizations to the management organizations; and from the management organizations to the operational organizations.
(2) From the perspective of the control levels of managers, the evaluation control in an evaluation control system mainly includes four levels: from the board of directors to the senior managers; from the senior managers to the department managers; from the department managers to the middle managers (e.g. project mangers); and from the middle managers to the employees.

Article 16 A complete evaluation control system is composed of several segments, which include strategic planning, evaluation indexes, evaluation procedures and methods in details.

(1) Strategic planning. Strategic planning is the start of the management control systems. Similar with budget control, evaluation control treats evaluation objectives as the beginning. Therefore, both the strategic planning and evaluation objectives are the starting point of evaluation control operating of systems. The evaluation objectives are the purpose and guidelines of the operation of the whole system, which determine the choices of evaluation indexes, the set of evaluation criteria and evaluation methods. The strategic planning should be established on the basis of strategic objectives; and the set of evaluation objectives should be based on the strategic planning.

    When an enterprise is going to set and carry out the evaluation control systems, it has to analyze the circumstance, make strategic planning on the basis of external environment and internal resources of the enterprise, and determine the Key Success Factors (KSFs) to set a proper objective. The KSFs are the decisive factors which affect the enterprise and the subordinate organizations to obtain the competitive advantages and to realize the success of strategies. The evaluation control can be reflected by strategic planning, which is connected with the whole enterprise strategic objectives; and also can be represented by evaluation indexes, which affect and control the business activities.
(2) Evaluation indexes. The establishment of the evaluation indexes is not only the implementation of evaluating objectives, but also the process of dividing Key Success Factors (KSFs) into specific responsibility objectives and giving orders to the practitioners. It is a decisive factor for an enterprise and its subsidiary organizations to divide KSFs into evaluation indexes, which can reflect limited and controlled aspects of these KSFs. After the governance quantified and divided the comprehensive objectives, it will be more manipulative with clearer responsibility.
(3) Evaluation procedures and methods. Evaluation procedure is the process of performing evaluation control. The research and establishment of evaluation

control is the foundation of internal evaluation control. It points the direction of operation work. It will affect the extent of the accuracy of final result: whether the evaluation process is correct or not.

Evaluation method which deals with the matter of how to evaluate is to obtain the evaluation result by using certain methods, evaluation indexes and standards. Evaluation index and standard will lose their functions and become isolated evaluation factor without suitable evaluation methods. There are three methods widely used in practice, which are single evaluation method, comprehensive evaluation method and multi-perspective balanced evaluation method.

5.5 Procedures and Methods of Evaluation Control System

Article 17 The evaluation control system should comply with a certain procedure. According to the procedures of management control system, the basic procedure of evaluation control system includes establishing evaluation objectives (i.e. decomposing strategic objective of evaluation control system), designing evaluation indexes and determining evaluation standards (i.e. developing standards of evaluation control system), selecting evaluation methods and forming evaluation report (i.e. managing control report of evaluation control system), producing and conducting evaluation results (i.e. assessing operational performance and relating to incentive of evaluation control system).

Article 18 Establishing evaluation objectives. The evaluation objective is the guideline and purpose of the whole system. It should be consistent with the enterprise's objectives, and serve them as well. Since the organization objectives realization relies on the strategic planning implementation, the evaluation objectives should be in line with the strategic objective and planning. However, for the evaluation control system having different control levels (e.g. the group evaluation control, the subsidiary evaluation control and the department evaluation control, etc.), it is allowed that there are differences in the specific objectives of different control levels evaluation.

The evaluation objectives are crucial for the setting of evaluation indexes, the determination of evaluation standards and the selection of evaluation methods. Setting up evaluation objectives is based on the strategic objective and planning. Meanwhile, it is necessary to make environmental analysis and confirm the key successful factors influencing the realization of organizational strategies.

Article 19 Designing evaluation indexes. Evaluation indexes refer to all the variables that are affected and controlled by the evaluation object during the evaluation. It should be designed based on the requirements of evaluation subjects and evaluation objectives. According to the control content, the indexes can be classified into financial performance evaluation indexes, management performance evaluation indexes, quality and technology performance evaluation indexes, and operation performance evaluation indexes. The selection of evaluation indexes types should

be at a multi-dimensional angle, such as single indexes and multi indexes, financial indexes and non-financial indexes, quantitative indexes and qualitative indexes, and the indexes of different computer basis (e.g. accounting basis, economic basis, and cash flow basis).

Especially, the non-financial indexes of an enterprise should basically contain the following three kinds (e.g. customer indexes, internal business process indexes, study and innovation indexes).

(1) Customer indexes. The customer index is adopted to measure the ability of the enterprise to create customer loyalty and satisfaction in the objective markets, generally including market share, customer acquisition rate, customer retention rate, customer satisfaction, customer profitability, product quality grade rate, product delivery rate, etc.
(2) Internal business process indexes. The internal management process index reflects the capabilities of an enterprise to create value in the innovation, management, after-sale service, etc. It generally includes product and the level of its design, ability of new product development, growth rate of R&D expenditure, efficiency of product lifecycle, capacity utilization rate, defective rate, safe productivity, waste rate, cost, etc.
(3) Learning and creativity indexes. The learning and creativity index measures the capacity of the enterprise to study and innovation constantly so as to adapt to the change in the environment. It mainly includes employee satisfaction, staff turnover, levels of employee of knowledge, staff training frequency, management ability, and updating degree of information system.

Evaluation indexes selection has direct impact on the implementation results of strategic planning. It also influences the examination that is to evaluate the realization of objectives carried out by those implementing strategic planning. The enterprise should quantify and specify the evaluation objective, so as to endow it with operability and clear responsibility.

(1) The establishment of an evaluation index system includes selecting evaluation indexes, confirming evaluation standards and assessing evaluation indexes, etc.

Selecting evaluation index is a key of setting evaluation control system. The behavior orientation of the evaluation indexes should be in line with the requirements of strategy implementation, i.e. the evaluation indexes should be sub-parts of strategic objective and planning. And it should reflect the key drivers of strategic objective attainment. The evaluation indexes have relation with the action taken by the persons who are evaluated, and the selection of evaluation indexes should consider their behaviors.

Confirming evaluation standards should have comparability, including the vertical comparison of the same departments during different historical periods, and the horizontal comparison among the departments during the same historic period or between the enterprise and its peer companies (or its rivals) within the same industry.

Assessing evaluation indexes should take the accountability and reliability of the indexes into consideration during the selection process. Therefore, the measurement of the indexes should be based on the verifiable material. Meanwhile, the selected evaluation indexes should be understood and acknowledged by the persons who are evaluated.

(2) The following principles should be complied with during the establishment of the evaluation indexes system:

The first principle is combination of results from all indexes and driving indexes. On one hand, the enterprise enables managers to understand the connotation of strategic objective achievement through setting the result indexes. On the other hand, the enterprise encourages the managers to attach great importance to the key driver factors.

The second principle is combination of financial indexes and non-financial indexes. Both financial indexes and non-financial indexes should be included in the evaluation indexes system, so that the system can reflect the production and operation activity of the enterprise more comprehensively. Meanwhile, it is essential to establish relationship between financial indexes and non-financial indexes as possible.

The third principle is combination of internal indexes and external indexes. The enterprise must reach balance between external indexes and internal indexes, and take the demands and objectives of different stakeholders into consideration.

The last principle is combination of different calculation basis indexes. The indexes of different calculation types have their own advantages and disadvantages. It is necessary to combine the indexes of different calculation bases as possible.

Article 20 Selecting evaluation standards. The evaluation standards are criteria for judging the management performance of evaluation objectives. Adopting different evaluation standards can contribute to different evaluation results. The selection of evaluation standards depends on the evaluation object and its objective. The types of evaluation standard adopted by evaluation control system, include historical standards, industrial standards and budget standards.

The results of the performance evaluation are judged on the basis of a certain evaluation standard. The enterprise should select proper evaluation standards according to strategic planning, evaluation objectives and respective features of evaluation standards.

(1) The following principles should be complied with during the confirmation of evaluation standards:

The evaluation standards should be regarded not only as the basis of the plan to reflect the decomposition of the strategic objective, but also as the basis of the evaluation to identify the problems and make proper modification.

The evaluation standards should be based on the objective performance instead of subjective judgment. It is better to quantify the evaluation standard; otherwise, if it cannot be quantified, it is necessary to clarify the standard specifically. Besides, the standards must represent the combination of rigidity and flexibility: they show

elasticity towards the objective influential factors, while they show rigidity towards the subjective influential factors.

The evaluation standards should not only have a certain challenge and higher performance incentives, but also have certain rationality and can be achieved through efforts.

The evaluation standards should be regarded as common concepts, common languages and communication tools. They are transparent and well-known to others. They should be understood and acknowledged by the persons who are being evaluated

(2) The following aspects should be paid attention during the confirmation of evaluation standards:

Distinguish the evaluation standards on absolute basis and relative basis. To ensure that the production and operation activities of the enterprise are in line with its strategic objective and planning, the operator must conduct regular and procedural supervision and control. So that it is necessary to select relative basis and evaluation standards, which can be regarded as the reference system of supervising and controlling the operation process.

Distinguish different evaluation standards of the relative basis. The evaluation standards that can mainly be used for the evaluation control are historical standards, industry standards and budget standards. The enterprise should combine these relatively basic standards together instead of focusing on one standard. Certainly, during the actual operation, it is feasible to give priority to one standard, which is supplemented by other relatively basic standards.

Distinguish the evaluation standards on individual as well as collective basis. If the individual basis is selected as the performance evaluation standard, the incentive principle should be well represented, avoiding "the equalitarianism" or "the communal-dining system". If some departments or posts need to adopt the evaluation standards of the collective basis, it is necessary to clarify the responsibility of each evaluated person, so as to prevent or weaken "thumbing a lift".

Article 21 Establishment of evaluation methods. Without reasonable evaluation methods, the evaluation indexes and evaluation standards will become isolated evaluation elements. It is to say that they will lose their own meaning. The enterprise should select evaluation methods according to strategic planning, evaluation objectives and respective features of evaluation standards.

The question that evaluation methods can solve is how to make evaluation. It is to say that adopt certain methods, apply evaluation indexes and evaluation standards, and then obtain the evaluation results. At present, the evaluation methods that are widely applied in practice are as follows: single evaluation methods, comprehensive evaluation methods, and multi-angle balance evaluation methods.

(1) Single evaluation methods are to apply the most comprehensive indexes to evaluate the management performance, so as to let evaluation object to realize the strategic objective. It takes Economic Value Added (EVA) as a typical example.

(2) Comprehensive evaluation methods are to apply a series of indexes to evaluate operation performance from different aspects. These evaluation methods can be divided into indexes decomposition methods and comprehensive indexes methods. The formers take DuPont financial analysis system and Palepu financial analysis system as representatives while the latter include comprehensive indexes methods and efficiency coefficient methods, etc.
(3) Multi-angle balance evaluation methods belong to evaluation methods of comprehensive indexes in essence. However, compared to the traditional evaluation methods, these methods focus more on the balanced relation and the casual or interactive relationship among the indexes of different types. In addition, it has a certain innovation on the design of evaluation indexes, the establishment of evaluation procedures and other aspects. Therefore, it is a relatively special evaluation method. It takes Balanced Scorecard and Performance Prism as typical examples.
(4) Some problems need to be dealt with during the process of selecting comprehensive evaluation methods, such as assimilation disposal of indexes, dimensionless of indexes, confirmation of indexes weight and so on.

First of all, evaluation indexes can be divided into three types related with evaluation standards, that is, positive indexes, inverse indexes and moderate indexes. Therefore, it is necessary to keep the consistency of direction as possible when selecting evaluation indexes, i.e. select positive indexes for all or inverse indexes for all as possible. If the problem cannot be avoided, it is necessary to be treated with assimilation.

Furthermore, different evaluation indexes may have different dimensions, and thus it will generate incommensurability. Therefore, dimensionless methods are needed. The basic practice is to convert different dimensions to the same unit. Therefore it is possible to transform a multi-index evaluation problem to a single-index evaluation problem, then to make comparisons and get results. Some comprehensive evaluation methods can solve “different dimensions” problem of multi-index system, such as comprehensive indexes methods, efficiency coefficient methods, etc.

Moreover, in a comprehensive evaluation indexes system, due to the different influence of each index on the comprehensive evaluation results, the significant influence of each index is reflected through endowing different weights to different indexes. The method of determining evaluation indexes weight can be divided into subjective types and objective types. Among them, the most common method for the subjective empowerment is Delphi method (an expert opinion method), while the objective empowerment includes factors analysis, principle components analysis, cluster analysis, etc.

Article 22 Preparing evaluation report. The evaluation report is the output information of evaluation control system. Besides, it is also the summative documents for the system. The performance evaluation committee office should obtain relevant information to calculate evaluation indexes; compare actual value with evaluation standards; analyze causes, responsibilities and influence in difference; form an evaluation report at last.

Article 23 Conducting evaluation results. The long-term effective operation of the evaluation control system can be ensured only if the evaluation results are connected with the benefits of responsible departments and the interests of employees in charge. The performance evaluation leading group should get a evaluation conclusion and propose incentive schemes (e.g. positive incentive plans or negative incentive plans) to the board according to the evaluation report. The enterprise should incentive effectively in order to operate better in the future.

Article 24 During the design of evaluation control system, there are multiple choices in confirmation of evaluation indexes, evaluation standards and evaluation methods, etc., considering the different backgrounds of enterprises. The enterprise should make selection according to specific backgrounds and principles, so that an efficient evaluation control system will be formed in an enterprise.

5.6 Environments and Conditions of Evaluation Control System

Article 25 If regulation control system and budget control system are the basic levels of management control system in an enterprise, evaluation control system should be at a higher level. Selection and application of evaluation control systems not only need good organizational culture, which can make staff understand the culture and idea of business better and pride of their own business, but also need specific strategic objectives, high quality of managers and good management foundations, which can provide good environments and right conditions for establishing evaluation control system.

Article 26 Formation of good organizational culture. Organizational culture usually represents the total of a series of interdependent value conceptions and behaviors. These conceptions and behaviors are accumulated for a long time and possessed by all staffs of enterprises. It is proved that an enterprise should have a good organizational culture: employees' and managers' behaviors are used to be consistent. They work hard to achieve the strategic objectives and operating directions. The harmony, positivity, organization and unified leaders are beneficial to improve the operating performance.

Article 27 Specification of strategic objectives. Evaluation control system is a kind of target control or target management. All the management control activities focus on the objective and evaluate the management based on the level of the completion of the objective. It is the actions direction throughout the entire management activities.

Article 28 Managers with high qualities. Whether managers can achieve the strategic objectives depend on the implementation of evaluation objectives. So operators who want the evaluation control systems work effectively should confirm the evaluation objectives to strategic objectives. To maintain the normal operation of the system and evaluate the control effect, it is not only requires the formation of a

cultural atmosphere but also requires managers to have a high quality and profound understanding of the organizational culture and values. Managers should consciously combine personal objectives with enterprise objectives and have a certain degree of team spirit and self-discipline.

Article 29 Good management foundation. In order to make the evaluation control systems operate well, enterprises need to have good management foundations. By only relying on these capital structures such as information systems, database, and organizational networks managers and employees can communicate with each other better and create more values and overall operating performance. Organizational capital is the innovation stage for talent of enterprise management. It is the platform where talented people can create value for enterprises.

Article 30 Scope of evaluation control system application. Different from regulation-based control systems and budget control systems, evaluation control systems cannot be applied to all enterprises. Compared with regulation-based control systems and budget control systems, evaluation control systems belong to a higher level of management control mode. Its characters and application conditions determine the limitation of its applicability. Evaluation control systems need a higher level of control environment, not only require enterprises which have good management foundations and clear strategic objectives, but also require a higher level of management quality and a good corporate culture. Therefore, to the enterprise, which has poor control environment and management foundations, establishes and applies an evaluation control system is difficult, and may not achieve required results. In contrast, to the enterprise, which has good control environment and management foundations, establishes and applies an evaluation control system is easier, and more likely to achieve better results.

According to the characteristics of evaluation control systems and commonly used evaluation methods, evaluation control systems are mainly adaptive for enterprises that implement decentralized management, enterprise groups with multiple organizational structures, knowledge-based enterprises that the intellectual capital contributes a lot, enterprises that face competitive pressures, and enterprises with a high cost of management.

Chapter 6
Application Guidelines for Enterprise Management Control No. 4—Incentive Control System

6.1 General Provisions

Article 1 These Guidelines have been formulated in accordance with the relevant laws and regulations, as well as the "Basic Standard for Enterprise Management Control" to motivate, guide, maintain and standardize the behavior of the managers (Management) and accelerate them to achieve the enterprise's objective.

Article 2 "Incentive control" in these guidelines refers to the activity realized by the organization to motivate, guide, maintain, and standardize the behavior of the organization members, and effectively realize the goals of the organization and the members, by the means of designing proper incentive mode and creating suitable working environment. The incentive process is just the integration of incentive and control.

Article 3 These Guidelines are mainly applied to the enterprise and other economic organizations. These Guidelines can also be used as a reference by the non-profit organizations to manage their activities, such as state organs, social organizations, public institutions, etc. The performance evaluation in the incentive control system is implemented referring to the guideline of evaluation control system.

Article 4 The management control department of the enterprise should be responsible for the whole incentive control system. The compensation committee and human resource department of the enterprise should be responsible for the establishment and implementation of the incentive control system of different levels respectively.

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6.2 Objectives and Principles of Incentive Control System

Article 5 The objectives of incentive control system include fundamental objectives and specific objectives as follows.

(1) The fundamental objectives of incentive control system are to motivate, guide, maintain and standardize the members of organization through designing an appropriate incentive model and suitable working environment. Incentive control system can motivate the members of organization, make them keep enthusiasm, initiative and creativity and then realize the goal of the organization and its members.
(2) The specific objectives of incentive control system are as follows.

The core objective of incentive control system is to lead managers to be hard-working under the rules. The motivation and method of manager's behavior is based on the incentive system of an enterprise. Only in this way, the benefit of the manager will be maximum. Incentive control system can lead the manager to do right things and do things in a right way to achieve the goal of the organization through stimulating the manager's behavior. If the standard of performance evaluation is not reasonable or practical, the benefit-oriented role of incentive control system will not be effective and it may lead to fail in achieving the goal of the organization as whole. Therefore, the enterprise shall address the above risks.

The key objective of incentive control system is to reduce the short-term actions of managers and make them to focus on long-term development. Because of the asymmetry of information, it is very hard for owners to master all the actions of managers. It is likely that managers' secluded information and actions will cause the problems of adverse selection and ethical risk and will damage the long-term benefit of enterprise. Incentive control system can coordinate the goals of managers and owners and make managers to create greater value for the enterprise through reducing their short-sighted behavior.

The basic objective of incentive control system is to help managers to achieve both managers own goals and enterprises goals as whole. Incentive control system can help managers to achieve the goals of owners or organization through reducing the deviation of goals between managers and owners. Therefore, the realization of organizational goals and individual goals are not in conflict. In fact, the effective incentive control system emphasizes on meeting the need of managers. In this way, the goals of managers and organizations will be accordant and the final goal of organizations will be achieved.

Article 6 Principles of incentive control system:

Incentive control system should comply with the following basic principles.

(1) The participation principle. It refers that all managers can participate in the enterprise incentive mechanism if they are willing to.
(2) The clarity principle. It refers that the performance evaluation index in the incentive control system must clearly reflect the corporate financial objectives and strategies.

(3) The stratification principle. It refers that the enterprise should design different incentive objectives and operation frameworks, and even different incentive modes which are aiming at the demands of different objects, so as to ensure the directionality and utility maximization of the incentive mechanism.
(4) The appropriateness principle. It refers that it is necessary to avoid the tendency of excessive incentive in the design of incentive mechanism and to design reasonable incentive mechanism based on their stage of development.
(5) The controllability principle. It refers that the performance evaluation index applied in the incentive control system should connect with the efforts of managers, and managers can improve compensation through their endeavor.
(6) The timeliness principle. It refers that the incentive control system should provide rewards in time and should enhance the managers' understanding towards the relationship between the business activity and compensation.

6.3 Categories and Contents of Incentive Control System

Article 7 Categories of incentive control system:

There are many kinds of incentive classification. The effect of incentive can be positive or negative, while the object of incentive can be others or ourselves. Incentive pattern can be divided into material incentive and spiritual incentive based on incentive factors. Material incentive includes salary, bonus, stock, stock options, benefits and allowances, etc. Spiritual incentive includes rights incentive, job incentive, honor and status incentive, etc. Material incentive also can be divided into short-term incentive and long-term incentive according to the timeliness of incentive. Short-term incentive includes annual salary system, bonus incentive, performance-related incentive, and income sharing plan, etc. Long-term incentive includes stock incentive, stock option incentive, MBO, etc. According to different environments and characteristics, the companies will choose different categories of incentive control systems. From the control levels point of view, incentives are divided into incentives of owners to top managers and incentives of top managers to lower level managers.

Article 8 Incentives of owners to top managers:

The top managers refers to CEO, deputy CEO, general manager, deputy general manager, chief financial officer, chief engineer, chief economic manager, board secretary, and other managers with equivalent post.

The incentive scheme applied by owners to top managers is designed and complemented by the compensation committee. The main responsibilities of the compensation committee are as follows.

(1) Designing the compensation plan of the top managers.
(2) Evaluating the operation performance of the top managers.
(3) Releasing and explaining the composition structure, proportion and causes of the compensation for the top managers.

(4) Regularly reviewing the rationality of the compensation plan.
(5) Taking charge of the implementation of the compensation plan.

Article 9 Incentives of owners to top managers mainly include stock incentive, stock option and annual salary system.

Article 10 Stock incentive is that modern joint-stock enterprises set their stocks as objects to motivate their directors, supervisors and senior managers and other employees in the long term. Its basic operation procedures are as follows.

(1) Determining the performance target at the beginning of the year, and generally taking the net profit and the rate of return on net assets as the evaluation indexes.
(2) Establishing the base line of the stock incentive and rewarding amplitude in the written form. It is feasible to determine the quantity of the manager's stock incentive according to their posts, working duration, contribution, etc. In general, the stockholding ratio of the manager should be more than 5 % of the total enterprise capital stock.
(3) Determining the specific form of managing the stock incentive. The enterprise should select a form that can maximize the function of stock incentive according to the actual situation, such as capital, stock source, etc.
(4) By the end of the year, if the manager has been up to the stipulated performance standard, the enterprise should carry out stock incentive according to agreement and the manager can get the stock.

Article 11 Stock option refers to the right of the buyer and seller to buy in or sell out certain quantity of stocks in specific time according to the established price. This right can be carried out or given up in the future, so as to reduce the market risk resulting from possessing the stocks directly at present. Based on the stock option system, the manager's income depends on the premium between the market price of the company's stock and the strike price of compensation contract. Because stock price reflects the company's future profit and the long-term development prospect of the enterprise, the system can better solve the contradiction between owners and managers, and provide long-term dynamic incentive for managers.

The following elements should be taken into consideration when formulating stock option plan.

(1) Rules of incentive objects. The objects of stock option plan could include the directors, supervisors, senior managers, the core technology (business) personnel, as well as other employees who should be motivated in listed companies, but should not include independent directors.
(2) Awarding period. The enterprise generally carries out stock option plan when the granter is employed, promoted and evaluated by the year-end performance assessment.
(3) Awarding quantity. The enterprise should determine the quantity of the stock option based on the work performance and compensation level of the granter. It is necessary to regard the maximum stock dilution that the current stockholders can bear during the awarding.

(4) Rules of conditions of stock option. If incentive objects include directors, supervisors and senior managers, the listed companies should establish a performance evaluation system and evaluation methods and put performance evaluation indexes as the implementation conditions of stock option plans.
(5) Executive price. For the listed enterprise, the executive price should be equal to or a little bit higher than the current price in the stock market on the awarding day. For the non-listed enterprise, it is feasible to regard the value of the net asset value per stock as the executive price.
(6) Executive time. The enterprise should design the "Executive Schedule", and control the granter to purchase the stock by stages and in batches. The executive schedule can be at constant speed or accelerating speed.
(7) Executive pattern. The granter can select some specific patterns, such as cash executive right, selling on that day, stock interchange, loan executive right, etc.
(8) Stock source. The enterprise should determine the stock source needed through issuing new stocks or stock repurchase, etc.

Besides, the enterprise should pay attention to the following questions when formulating correctly stock option:

Firstly, clear property right and improved modern enterprise system are necessary. The precondition of applying stock option is that the stock can be divided. It should be priced in the market at any time. So the clear property right will be at the first place when applying stock option. At the same time, the improved modern enterprise system is also necessary. The boundary between owners and managers should be clear. Managers should play the decisive role in daily operating.

Secondly, the market and the enterprise must develop (grow). If the market and the enterprise do not have the ability to develop, then the stock cannot turn to high revenue and even minimize risks. Then the stock option plan will not be useful.

Thirdly, the incentive object should be clear. The object of stock option plan must be professional managers, who are seeking maximum profit. If the managers are selected by government, they will not take responsibility for enterprises failure. Their benefit will be different from the stockholders' and the incentive will be failed.

Fourthly, the assessment indexes should be diversified. If the assessment index is simple or incomplete, the management will pay attention on short-term benefit. The long-term development will be ignored. So, the performance index should be diversified and focus on uniting financial indexes and non-financial indexes, accounting-basic indexes and marketing-basic indexes, absolute-performance indexes and relative-performance indexes.

Article 12 Annual salary system is an incentive compensation system which determine the income and compensation of the managers by taking the year as the unit. Its basic operation processes are as follows.

(1) Determining the compensation structure. The annual salary of the managers is divided into basic salary and risk income. The basic salary is mainly to guarantee the daily living needs of the managers, which is achieved by multiplying the average salary of the staff with certain adjustment coefficient. The risk income

is divided into value-added annual salary and reward salary. The former one is responsibility-target annual salary, and the later one is extra reward enjoyed after overfilling the target.

(2) Determining the risk mortgage. It is mainly regarded as the capital source from the punishment towards the managers who do not fulfill the objective. Besides, it can restrain the manager to make a false report about the profit to some extent. The risk mortgage can be paid in full and drawn from the risk income on yearly basis .i.e., year after year.
(3) Determining the link indexes. It should comprehensively apply the profit, ROE, maintenance and appreciation of assets value, the rate of technology innovation, the rate of average income growth, etc. The evaluation standards of each index should be based on the average advanced level of this industry and determined according to the actual value of the previous years.
(4) By the end of the year, if the manager has finished the stipulated index, then he/she can get the risk income, otherwise, their risk income will be deducted, and if it is not enough, the risk mortgage and basic salary will be deducted correspondingly.

Besides, an enterprise should pay attention to the following questions when it formulates correctly annual salary system.

Firstly, an enterprise should reasonably determine the basic salary. The basic salary should be determined according to enterprise size and local living standard and can be slightly higher than the wages of employees of enterprises. Lower basic salary can not satisfy the needs of basic life, and higher basic salary can inhibit the effect of risk-based incentives.

Secondly, an enterprise should accurately formulate the proportion and amount of salary increase. The main function of salary increase is to improve enterprise economic benefits through motivating top managers by the risk of income. The basis of determining salary increase should be the size of enterprise and the level of risk.

Thirdly, an enterprise should diversify the index system of evaluation. Simple market-value indicators and accounting indicators have advantages and disadvantages. These two kinds of indicators should be combined to use in practice and consider the enterprises' social responsibility.

Fourthly, an enterprise should improve constraint mechanism and restraint on-the-job consumption. Also enterprises should reinforce board of directors and board of supervisors to play their supervisory roles through establishing and perfecting an effective corporate governance structure.

Article 13 Incentives of top managers to lower level managers:

The lower level managers refer to all managers except top managers.

The incentive scheme for the lower level managers is designed and implemented by the human resource department of the enterprise. The main responsibilities of the human resource department are as follows.

(1) Post analysis and evaluation.
(2) Compensation investigation and positioning.
(3) Compensation structure design.

(4) Implementation and modification of compensation system.

Article 14 Incentives of top managers to lower level managers mainly include post salary system, bonus incentive, performance-related incentive, income-sharing plan and spiritual incentive.

Article 15 Post salary system refers to the salary grading system which determine the salary standards according to the labor characteristics and work value of the post of the managers. It requires determining a reasonable, systematic and stable post structure according to the operation target of the enterprise, and thus it is feasible to establish a set of compensation system that is in line with the internal fairness principle, and deal with post evaluation and salary standards. The post salary system is mainly composed of the following contents.

(1) Salary grading.
(2) Salary standard.
(3) Post name.
(4) Business criteria.

Article 16 Bonus incentive is an auxiliary form of working reward, i.e. reward of excessive work. The following problems should be attached great importance to bringing the incentive effect of the reward into full play.

(1) The rationality of the target. For the reasonable task target, it is necessary to consider the historical level and development potential. Besides, there is some possibility to finish the task with such target and it should be properly higher than the current power.
(2) Providing proper incentive force. It is necessary to consider the industry of the enterprise, local economic development level, income level of the resident, bearing capacity of the enterprise and psychological expectation of the employee in the confirmation of the bonus quantity.
(3) Paying attention to the fairness principle. It is necessary to show fairness not only on the absolute quantity of the bonus, but also on the relative quantity. During the procedure of the specific operation, it is necessary to fully advocate democracy, enhance transparency as much as possible and avoid black box operation.
(4) Paying attention to the bonus proportion, frequency and time. For the managers who have made great effort, gained obvious achievements and made great contribution during the work, they should be rendered with great bonus, so as to play a guidance role. Rewarding for the few staffs who have well finished the task can not only encourage the good staffs, but also attract others who are in the middle place. It is necessary to arrange the rewarding time in advance, and pay attention to the timely rewarding principle for the intrusive and temporary work.

Article 17 Performance-related incentive is an incentive method which has a positive correlation between the total salary and economic benefit. The economic benefit mentioned here refers to the proportion relation between the labor outcome

and the labor consumption during the production and operating activities of the enterprise. The basic operation procedures of the performance-related incentive are as follows.

(1) Determining reasonable cardinality of the total salary of the specific department.
(2) Determining the cardinality of the economic benefit index.
(3) Determining the proportion which links the cardinality of the economic benefit index and the total income and economic benefit.
(4) Determining different economic index systems related to the total salaries according to the specific situation of different enterprises.

Article 18 Income-sharing plan refers that the managers and the employees share the financial income according to the predetermined formulas that reflect the improvement of productivity and profit margin. It mainly includes profit sharing plan and cost saving plan.

(1) Profit sharing plan carries out incentive through endowing the employees with certain residual claim. It includes three modes.

Fixed-ratio profit sharing, i.e., distributing profit to all employees according to the certain ratio profit.
Step-ratio profit sharing, i.e., establishing different sharing proportions in sections according to the profit level of the enterprise. Such profit proportion can be designed from low to high or high to low.
Surplus profit sharing, i.e., taking a certain relatively low profit index of the enterprise as the cardinality. The surplus profit that exceeds the cardinality is shared by the managers or the employees according to the different posts and performance evaluation results.

(2) The cost saving plan emphasizes the participative management. It encourages to reduce the cost through sharing cost saving. Its basic procedures are as follows.

Determining the objects of cost sharing plan, including department, personnel, time, and range.
Determining the overall scheme of the sharing plan, such as the initiative line of the cost sharing, sharing proportion, the rate of change of the cost sharing initiative line in the sustainable development, etc.
Determining the relation between the cost sharing plan and post compensation.

Article 19 Spiritual incentive is to improve a series of immateriality pattern to meet individual psychological needs, change its ideology and stir up work vigor. The following problems should be attached great importance in the implementation of the spiritual incentive.

(1) The shifting down of the power is favorable for meeting the managers' power needs. The power can be shifted down properly and it can also realize the

organic combination of the responsibilities and power. It can not only meet the managers' power needs, but also can meet their achievement needs.

(2) Providing the opportunity of individual development and promotion. The enterprise should try every means to create opportunities of study, training and further study for the managers. Besides, it should establish promotion mechanism, and realize structure balance in the organization structure design and personnel allocation. Each manager can have the opportunity and possibility of promotion and income will be increasing when they have a certain qualification.

(3) Strengthening the enterprise management and establishing good enterprise order. "Fair, Justice, and Public" is a kind of incentive for the managers. The enterprise should create good work environment that gives full scope to the talents for the managers.

6.4 Procedures and Methods of Incentive Control System

Article 20 As control has different degrees, management control system includes strategic goal analysis, control standards, manager control report, performance evaluation and managerial compensation. As a mode of management control system, incentive control system should include several parts: strategic planning and incentive objective, incentive option and standards formulating, constraints in motivation, performance evaluation and managerial compensation.

Article 21 Strategic planning and incentive objective:

Strategic planning, which involves the decisions of markets, products, customers, technology and human resources that must be included in managers' incentive goals, is the composition of the enterprise strategies. Incentive controls are parts of strategic planning. Strategic planning is the specification and institutionalization of enterprise strategic goals and is the premise and foundation of Incentive Control Systems, Regulation Control Systems, Budget Control Systems and Evaluation Control Systems.

Article 22 Incentive methods and standards formulating:

Incentive methods are those things that can make motivated persons to be interested in enterprise goals and contribute their enthusiasm, spiritual and physical power to the goals. Incentive methods of material or spiritual are the form of incentives or the functional carrier of incentives. Common incentive methods include annual salary system, bonus, gain sharing plan, stock incentive, stock option incentive, management buy-out, etc. Each kind of incentive methods has different incentive effects, so enterprise should make choice a type of incentive method as according to size of enterprise, industry, stage of development, enterprise culture and so on.

The standards formulating of incentive system: Firstly, to clear the driving forces of organizational goals or the elements of the goals. Secondly, to find out the elements that can help to carry out the strategic goal. Thirdly, to confirm the risk variable of reward to be the key point of incentive control. Fourthly, to formulate the advanced and feasible standards of incentive control.

Article 23 Constraints in motivation:

Constraints in motivation belong to the "controls" of incentive controls and can control the process of management and monitor the results in order to regulate and constraint managers' behavior. Like other rational risk-averse people, managers will also trade off benefits and risks. To avoid short-term goals and those business strategies which could lead to generating too much risk for the owners, it is necessary to control rationally the risks in incentives. Constraints in motivation include the improvement of corporate governance structure, the consolidation of the roles of the remuneration committee and audit control, the constraints or limitation of financial behavior in the compensation contracts.

(1) The approaches of improving the corporate governance structure, and enhancing the control and supervision of the senior managers include the following items.

Establishing and improving the agency structure of state-owned assets.
Realizing the diversification of property rights.
Improving and perfecting the principal-agent structure of state-owned assets.
Strengthening the function and effect of the general meeting of stockholders, board of directors, and board of supervisors.
Actively bringing the effect of the independent board of directors into full play.
Establishing information disclosure system of the great events, and forecast system of financial information etc.

(2) Restraint patterns of compensation committee include:

Reviewing the responsibility execution status of the senior managers.
Conducting annual performance evaluation on the senior managers.
Supervising the implementation status of the enterprise compensation plan, etc.

(3) Restraint of the debt contract generally includes commitment contract and negation contract.

Commitment contract stipulates the behavior that the managers must abide by, including: the consistency of commitment loan usage and loan purpose, promising to report financial performance and position to the creditors, and stipulating corresponding financial standards, promising to accept review, etc.

Negation contract directly restraints the behavior that managers may do harm to the interest of the mortgagee, including restraining gross liabilities, capital expenditures, leasing, cash dividends payout, stock repurchase, purchase, asset sale, guarantee, etc.

(4) The restraint of the financial behavior is to restrain the following behavior in the compensation contract: dividend distribution policy, stock split and consolidation, stock repurchase, confirmation of stock option value, and exercise stock source, etc.

(5) The confirmation of accounting method is that the compensation contract determines the methods of accounting confirmation, accounting measurement, accounting disclosures that affect the incentive effect.

Accounting conformation is to determine the time, value, and element attribution of the confirmation of the incentive methods

Accounting measurement should determine the usage range of the measurement attributes, such as fair value, historical cost, inherent value, etc.

Accounting disclosure should determine the scope of internal table disclosure and external table disclosure.

(6) Audit control is to evaluate and improve the effectiveness of risk management, risk control and governance procedure through systematic and standard methods. From the subject of the audit, the external audit is mainly applied by the owner to restrain the senior managers. The internal audit is applied by the senior managers to restrain the subordinate managers.

Article 24 Performance evaluation:

Performance evaluation is to use a certain index system and select suitable standards and apply reasonable methods to make value judgment for the enterprise's business performance during a certain period. Performance evaluation is not only belongs to evaluation control system but also is an important part of Incentive Control System. A reasonable performance evaluation system can make incentive control system to play a very big role. Performance evaluation in incentive control system includes evaluation index, index standard and index calculation, etc.

The selection of evaluation indexes are as follows:

(1) Stock price. stock price that is associated with managers remunerations can reflect the future of the enterprise value and stockholders' direct interest requirements, but stock price is affected by a variety of factors in the capital market such as capital market efficiency, noise traders and so on.
(2) Net profit and return on equity. Accounting indexes associating managers' remuneration such as net profit and return on equity can reflect the results of the production and business operation activities in the past, however, accounting indexes would be often affected by the accounting policy and manipulated by top managers, and in many cases, after business activities are finished, current accounting income would be calculated and it would be less timely.
(3) Economic value added indexes. Economic value added indexes try to combine the advantages of accounting index and market value index, but EVA's usefulness has yet to be tested in Chinese enterprises.

The principles of establishing the evaluation standards are as follows:

(1) The suitability principle. The standards should be adaptive, which can reflect the new requirements of enterprise management caused by environmental changes.
(2) The advancement principle. The standards should be advanced, which is helpful for managers to improve operation and management level.
(3) The universality principle. The standards should be generic to facilitate the comparison between enterprises.

(4) The appropriate principle. The standards should be appropriate. High standards will affect enthusiasm of managers and may lead to demotivation, but too low standards also could affect the motivation and lead to “ratcheting effect”.

The methods of evaluation:

(1) Traditional financial evaluation. Traditional financial evaluation methods are simple and clear, easy to grasp and understand but not conducive to appraise enterprise overall performance. For the enterprises which have low level of management, traditional financial evaluation methods are still applicable.
(2) Balanced scorecard. Balanced scorecard methods are the most efficient but are very complex and difficult to apply, and improper using may cause failure. Financial evaluation indexes of balanced scorecard can choose accounting data and financial indicators or can contain the indexes of EVA. These methods should be used in combination and make the best of the both methods.
(3) Economic value added. The effect of EVA is in the middle of that of traditional financial evaluation and balanced scorecard, but the application process is more complex and project adjustment is arbitrary. EVA is like the traditional methods while avoiding the weakness of traditional methods in benchmarking with the help of the idea of the balanced scorecard. These methods should be used in combination.

Article 25 Management compensation:

The subject of incentive control system is the managers. The control motivation of managers must have a relationship with their benefit. The effectiveness of incentive control will guarantee the system to be operating in long-term only in the way of combining the management compensation. From this point, the management compensation is not only the termination but beginning of incentive control system. To the situation of operating the incentive control system, the stock option should be the key point. Stimulating managers in the way of stock allotment, paying attention on the long-term incentives and being rewarded by increased stock price, the incentive control system can be operating smoothly and achieve the final goal of owners.

6.5 Environments and Conditions of Incentive Control System

Article 26 Fundamentally, the risk that need to be controlled by management control system is mainly caused by humanity including bounded rationality and opportunism tendency. The prerequisite for using Incentive control system, which is a kind of advanced control method, is due to existing of relatively perfect external and internal environments that can restrain weakness of humanity.

Article 27 There are some necessary external environment elements for applying incentive control system, including formal institutions like improved security market supervision system, normative and compete-effective professional managers market and non-formal institutions like total social values, etc.

Under the well improved security market supervision system, the stock price can reflect the performance and value of an enterprise effectively. Furthermore, it can reflect the value of contribution of managers to the enterprise effectively. If the security market supervision system is not well improved, the insider transactions and market investment will increase. The stock price will not reflect the real state of operation of an enterprise. The managers of enterprise will vest the stock option for interest through the advantage of information and damage the overall interest of the enterprise. The role of stock incentive will be out of work.

Under the normative and compete-effectively professional managers market, the stock incentive can play a positive role through the flow and replacement mechanism of professional managers. The managers market can provide good market-selection mechanism. This kind of mechanism can show the ability and effort of managers through the professional reputation which is based on the long-term work performance of managers. It is helpful to select and appoint managers and formulate the basics of applying incentive control system.

Noble social values means that in every society, there are people who have got noble values and they have mutual trust between them. All these conditions can make people cooperate with each other with relatively low transaction costs, and means that the risk caused by humanity including bounded rationality and opportunism tendency is relatively less and incentive control system can be used.

Article 28 The internal environment of applying the incentive control system is when the enterprise should have perfect formal institution including regulation control system, evaluation control system, budget control system and perfect structure of corporate governance, perfect structure of corporate governance, and noble moral level of enterprise's personnel etc.

One precondition of operating incentive control system effectively is that the enterprise has perfect regulation control system, evaluation control system and budget control system. Therefore, only when an enterprise has perfect management foundation and control environment, then the incentive control system will play its big role. The incentive control system is a kind of target control. To achieve the target, the enterprise should have improved regulation control system, reasonable budget control system and effective evaluation control system.

Another prerequisite for operating incentive control system is perfect structure of effective corporate governance that can be improved on the condition that the authorities and responsibilities of stockholders, board of directors, board of supervisors, the managers and ordinary employees are very clear. Every level of company has its responsibilities and authorities, and also every level has limits and supervises each other.

Like total social values of external environment, noble moral level of enterprise's personnel can also decrease transaction cost in enterprises and make personnel to cooperate with each other in higher efficient way. The enterprise that can use incentive control system to control risk caused by humanity must take moral level of personnel into account otherwise it is very likely that people do harm to the enterprises for their own benefits.

Part IV
Cases of Implementing Enterprise Management Control

Chapter 7
Regulation Control of China Southern Airlines Company

7.1 Case Introduction

7.1.1 Basic Information of China Southern Airlines Company

China Southern Airlines is an air transport business subordinated to the China Southern Airlines Group, headquartering in Guangzhou. It has 3 branches, 5 holding subsidiaries, 18 domestic business departments and 52 overseas offices, with the total assets of RMB 94.7 billion, and it is listed in New York, Shanghai and Hong Kong. China Southern Airlines has the largest number of the transport aircraft, the most developed route-network and the largest volume of passenger transportation. It has formed a densely covered domestic and Asian airline network with Guangzhou and Beijing as the center hubs at present. The leadership of the company is always stressing that the good condition in the corporate governance and internal control is the most important factor to the steady progress.

7.1.2 Background of Implementing Regulation Control System

In 2006, China Southern Airlines began to build and improve the Regulation Control System gradually. This is mainly based on the following reasons. Firstly, there were entrusted financing losses, management frauds and other events in 2004 and 2005, which showed that it already had obvious loopholes and its regulation control at that time could take no effect of the risk control. Secondly, there was a net loss of RMB

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1.794 billion in 2005 due to the deficiency of design and execution of the regulation control system. This hindered the improvement of the company's management and operating performance. Thirdly, as the Sarbanes-Oxley Act was promulgated in 2002, it proposed to strengthen the control requirements for all corporations listed in America. Along with the deadline for the implementation of the act, China Southern Airlines, as a company listed in the USA, naturally needed to improve the regulation control system as the most important thing. Above all, if China Southern Airlines wants to achieve its strategic goals, i.e., "having the largest number of transport aircraft, the most developed route network and the largest volume of the airline passengers", it should integrate the existing regulation control system and improve it continuously.

7.1.3 Process of Implementing Regulation Control System

Since June 2006, China Southern Airlines has established a specific department responsible for the Regulation Control System, so as to have a clear responsibility. At the same time, in order to meet the relevant regulatory requirements of the listed company, it sets up the Sarbanes-Oxley internal control project team to assess the effectiveness of internal control operation. In 2007, China Southern Airlines developed a comprehensive plan of the risk management based on the "Comprehensive Risk Management Guidelines of the State-owned Key Enterprises" published by the SASAC (State-owned Assets Supervision and Administration Commission), and carried out the comprehensive risk management, which was clearly organized by the legal department and the comprehensive budget management with "the Budget Management System of China Southern Airlines Co., LTD" at the same time. And it disclosed the internal control self-assessment report, internal control assurance report and social responsibility report, while there were a very few listed companies did such kind of things. In September 2008, the completion and putting into use of the risk management information system marked that the company preliminarily realized the information management. On April 15, 2009, based on "the Notice to Further Strengthen the State-owned Key Enterprises Business Regulatory on the Derivative Financial Instruments ([2009] No. 19)" from the SASAC, China Southern Airlines issued the "Management Regulations about the Hedging Business of China Southern Airlines Company", which strictly ruled that the hedging operations should be approved by the board before implementation. Visibly, China Southern Airlines control system is a phased completion of the process.

7.1.4 Effects of Implementing Regulation Control System

As you see above, China Southern Airlines began to improve the Regulation Control gradually since 2006 and enhanced the overall profitability as the capability of controlling the risk and cost increased. On September 15, 2006, the article from the

SASAC website, “China Southern Airlines controls the cost through the work with the obvious effectiveness”, pointed out that “cost control” was the basic task of all work in the Southern Airlines with increasing high oil prices today.

In 2008, due to the impact of the international financial crisis, China Southern Airlines fell into a predicament, but successfully reversed the adverse situation in 2009. There were 66,280,000 passengers traveling with it annually, which ranked the first in Asia and the fourth in the world. And it realized a net profit of RMB 358 million attributed to the listed shareholders increasing by 107.41 %, compared with the last year. These achievements are inseparable with the meticulous corporate governance and effective management control. On June 11, 2010, according to the Shanghai Securities News, China Southern Airlines was one of the top 100 enterprises in China on the internal control, ranking the twelfth place, and was only second to China Merchants Bank among the Central State-owned Enterprises. Its stringent norms and effective operation of the system have a profound impact on the healthy development of the company.

7.2 Case Analysis

In a fiercely competitive market, China Southern Airlines outshines the others, leading to China aviation industry, due to the perfect Regulation Control System, which includes the perfect regulation content, the effective regulation evaluation, and the sound regulation supervision.

7.2.1 The Perfect Regulation Content System

From the perspective of the content, the control system of China Southern Airlines includes the following three aspects:

① Rules of Strategic Control
Rules of strategic control include the articles of association, the enterprise strategic planning, the enterprise organizational structure and corporate governance, etc. China Southern Airlines established the corporate governance structure and the rules of procedure in accordance with the requirements of the norms of the listing companies. It cleared the responsibility and authority of the decision-making, execution and supervision, and it insisted on the separation of incompatible duties and ensured the clear accountability between different departments and posts with mutual restraint and mutual supervision. In all, it formed a mechanism of balance of the scientific and effective division of duties and checks, based on “Company Law”, “Securities Law” and “Articles of Association”.

② Rules of Management Control
Rules of management control include the rules of financial control, rules of personnel control, rules of purchasing control, rules of marketing control, rules of

production and technology control and rules of cost control, etc. For example, the comprehensive budget management control system requires that all the production and business activities are put into the budget control, the management benefit analysis should be held regularly, the performance should be compared with the budget and the differences and reasons should be analyzed timely, so as to make the company adjust the business strategy timely.

③ Rules of Task Control

Rules of task control refer to standardization of activity behaviors by the managers of responsibility center. It mainly includes the rules of production process control, rules of purchasing process control and rules of storage process control, etc. All business units and functional departments in China Southern Airlines have the standardized management manual which can help it adjust the business management links and processes to the change of internal and external business environment. For example, in order to ensure the safety of flight, China Southern Airlines established the perfect rules of task control system, such as flight training system, simulator training system, and the emergency training system. These systems can better promote the daily task control requirement of the aircraft department.

7.2.2 The Effective Regulation Evaluation System

Constructing the regulation evaluation system must comply with the practical and suitable principle. The control system is not a fixed system, but formulated according to the enterprise's own actual situation and the dynamic environment. Therefore, it should respond to the dynamic environment appropriately and timely. Then, how to improve the enterprise's regulation system continuously?

The regulation evaluation system of China Southern Airlines gives us many inspirations. It was established in December 2005 by the evaluation project committee and project team. Since 2006, China Southern Airlines began to assess the effectiveness of the regulation system by itself, and to employ the external auditors to give a further verification of the opinions to the self-assessment report. In this process, once finding the system defects, it corrected them timely. So that it not only expanded the breadth and depth of management control and promoted the improvement of the corporate governance structure, but also improved the overall management capacity of the company, and enhanced the ability of risk identification and hedging.

7.2.3 The Sound Regulation Supervision System

The Regulation Control System can not work without supervision. Effective supervision can ensure the execution of regulations in continuity and also their effectiveness in the future. China Southern Airlines established a sound regulation supervision

control system to guarantee the implementation of the regulation control system. The audit committee is the subcommittee of the board of directors, and it is the watchdog to make an effective supervision of the execution of the regulation system. And the board of supervisors is in charge of the continuous checking and verification on design and operation. Audit department, safety supervision department, standard operation management department and other functional departments make regular or irregular special inspection and assessment in the field of the individual business area to ensure the regulation requirements and effective operation. The audit department shall regularly give reports of working progress to the audit committee, and the audit committee should review the internal audit work plan during the report period, and listen to the audit department's report on the construction and implementation.

At the same time, the implementation of the regulation supervision control system needs effective rewards and punishments mechanism. It can not only arouse the enthusiasm of the staff, but also ensure the effective implementation of the regulation control system through punishing those who violate regulations. For example, China Southern Airlines strengthened the mechanism of rewards and punishments, formulated and issued its aircraft repair factory fleet flight punctuality assessment and incentive scheme in order to improve the efficiency of flight security. Considering the direct flight fleet security and safety pressure, the normal inspection scope is mainly in the workshops of tube fleet aircraft repair shops route 1 and 2, the repair shop of tube airbus aircraft fleet which is in charge of the technical training room and the missile detection workshop, and aeronautical material management room. In accordance with the quantitative target, the mechanism of the rewards and punishments and the fairness principles, the above departments should be assessed about the flight security ability monthly and release the results. It requires striving for timely and effective treatment to avoid the flight delays, fully arousing the enthusiasm of the line maintenance and technical personnel in the aircraft repair factory, reflecting the staff job efficiency and playing the role of benign interaction cycle. In the process of assessment, it assesses the completion of the indicators, and then makes rewards and punishments piecewise. In order to further refine the assessment criteria, it makes the detailed assessment criteria such as the normal security, the rate of no precision in a thousand times, the aircraft malignant delay and so on to avoid the fuzzy and uncertainty of the evaluation index, which makes the assessment just formality.

7.3 Case Implications

7.3.1 Adopting Regulation Control System Based on the Environment

The key point to make full use of the Regulation Control is that the Regulation Control must fit the organization environment, which includes the internal and external environment. The starting point should be the external environment, the

Regulation Control System is determined by the organization's external environment firstly, and then its contents are determined according to the internal environment. Only in this way can it guarantee the adaptability of the Regulation Control System and assure that the Regulation Control System plays an effective role. And the enterprises should be combined with the actual situation to design the contingency regulation control system.

In 2006, China Southern Airlines emphasized the importance of the establishment of the Regulation Control, mainly because of the changes of the company's internal and external environment. On the one hand, the SEC and the Securities Regulatory Commission of China strengthened the control of the listed companies. There were more demands and higher standards in perfecting the regulation system. On the other hand, there was the trusted wealth management losses, management frauds, operating losses, etc., appearing in China Southern Airlines, which showed that the system did not adapted to the needs of the development of the company. These problems not only interfered with the ascent of the management level, but also hinder the achievement of strategic goals. Therefore, the existing regulation control system needs to be integrated and improved urgently at that time.

7.3.2 Grasping the Role of Regulation Control System Comprehensively

As the basis for other control systems, the Regulation Control System has some obvious advantages. Firstly, the standards of the enterprise behavior are distinct. It has a clear direction and the specific provisions of the responsibilities and rights, which would ensure the implementation of the management control thoughts and prevent the unclear responsibilities and the prevarication. China Southern Airlines established the corporate governance structure and the rules of procedure in accordance with the requirements of the listing company specification and cleared the responsibility and authority of the decision, execution, supervision and other aspects. And it insisted on the separation of the incompatible duties, and formed the scientific and efficient mechanism of balance and division of duties to ensure the accountability, the mutual restraint and supervision between the different departments and posts. Just because there are clear standards of the enterprise behavior, China Southern Airlines has no internal chaos, and there is a solid foundation in the operation and development for future.

Secondly, it has the simple operations, the low requirements to the environment, and is easy for the full implementation. The role of the Regulation Control System lies in that it regulates the management and staff behavior through the regulations. The regulations ask the managers and staffs to follow the rules and do the right things, do not violate the company goals, and make clear what to do and what not to do, so that the managers and staffs could understand the requirements of an

organization fully, and operate easily. And this is helpful for the implementation of the regulation. The requirements of the environment is quite low, hence, it is not limited by the tough conditions. No matter what kind of organization they all need a set of regulation system to formulate the behavior of the managers and staff. Therefore, regulation control is suitable and applicable to all the organizations or enterprises. No matter how small the business is, or the large firm like China Southern Airlines, the effective Regulation Control System is the key and necessary. Mao Juan, Deputy General Manager in the audit department of China Southern Airlines said, it can not solve all the problems, but can solve more problems through the sound regulation system. So we can see the function of the Regulation Control System.

Just like the coin has two sides, we all know the merits of Regulation Control System, but it also has its limitations and defects. Firstly, it restricts the managers and staffs' subjective initiative. Secondly, it lacks direct connection with business goals and it mainly focuses on the qualitative aspects of control which lacks the quantitative control. Therefore, China Southern Airlines does not only adopt Regulation Control System, but also considers the budget, evaluation and other control modes. For example, it implements the comprehensive budget management according to its special regulation of "Budget Management System of China Southern Airlines Company".

7.3.3 Improving Regulation Control System Through the Evaluation System Constantly

The evaluation of the Regulation Control System should be emphasized through the whole process of the management activities, and it should have the systematicness, which means each part of the evaluation is mutually coordinated and integrated. No matter how perfect the regulations are, if not let to perform or not perform well, they are all in vain. The operation quality must be paid close attention to make the Regulation Control System function well. Through the evaluation and analysis of the problems in the process of implementing the regulation, and taking effective measures to solve them, we can improve the quality of the Regulation Control System.

The experience of China Southern Airlines tells us that we should establish the evaluation system, set up or designate specialized agencies internally, and make self-assessment on the effectiveness of the regulation system regularly and irregularly. It can also employ external auditing companies to do these works. Once finding the defects in this process, the enterprise must make the corrective plan timely and implement it, which not only expands the breadth and depth of the company level of the control and management, promotes the continuous improvement of the regulation control, but also enhances the overall management level and ensures the effective implementation of the corporate strategy.

7.3.4 Improving the Execution of Regulation Control System by Strengthening Supervision and Implementing the Rewards and Punishments

When the enterprise has the perfect and sound Regulation Control System, the execution becomes the question on the table. No matter how perfect the system is, it also needs a person to do it and make it most effective. Therefore, the enterprises need to improve the execution of the regulation by the supervision and implementation of the rewards and punishments. In order to fully play its due role of Regulation Control, all units should supervise the process of implementation and establish the incentive mechanism properly. Through the supervision, we can check whether the Regulation Control System is implemented effectively, whether it could continue feasibly, and whether there are some defects, so that we can improve and perfect the Regulation Control continuously, and ensure it smoothly. The rewards and punishments mechanism enhances the enthusiasm of the employees, maintains the authority of the regulation, and improves the execution and operation of the Regulation Control System.

China Southern Airlines attaches great importance to the supervision and inspection of the Regulation Control System. The managers are responsible for the day-to-day running of it in order to maintain the authoritativeness and effectiveness. The board is responsible for the completeness, reasonableness and effectiveness of the company's regulation system. In order to encourage the enthusiasm and creativity of all managers and staff, China Southern Airlines carries out the target management and accountability system, layer upon layer to carry out the effective implementation of the regulation system, establishes a system and the rules of the rewards and punishments with operability, proposes the commendation and reward on the internal organizations and personnel who do well, and gives the corresponding punishment to those who violate the regulation. These measures all together improve the execution of the regulation in China Southern Airlines greatly.

Chapter 8
Budget Control of Baoshan Iron & Steel Company

8.1 Case Introduction

8.1.1 Basic Information of Baoshan Iron & Steel Company

Bashan Iron & Steel Co., Ltd. (hereafter Baosteel) is China's biggest and most modernized iron and steel company. With its comprehensive advantages in integrity, talent, innovation, management and technology, Baosteel is world's leading company in global steel market. The World Steel Guide has been ranked 3rd because of its comprehensive competitiveness in international steel market, and regarded it as the most promising steel company in future.

8.1.2 Background of Implementing Budget Control System

Steel industry is in great distress and continuously struggling since the inception of financial crisis 2007–2008. Steel prices are experiencing continuous downfall. The development of steel companies faces various challenges. Under the following background, Baosteel applied budget control systems.

① The influence of government macro control. The "Twelfth Five Year Plan" proposed the development of energy-saving and environment-friendly enterprises vigorously. Thus, as a "high energy consumption, high pollution" industry, the steel industry has become the focus of rectification.

This case is adapted from: Application of Strategy Oriented Budget Control in Baosteel Company. Ping Shi and Guohua Chi. "Finance and Accounting (finance edition)", September, 2010. The case adapters: Guohua Chi, Hao Xing and Yue Zhao.

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② The marginal effect of domestic investment in promoting economic growth experienced continuous decline, which reduced possibility of infrastructure projects in the future. A series of macro economic policies by Chinese government made steel industry enter a long downturn period. In view of the marginal effect of current promoting economy investment, industries which are closely related to the iron and steel industry, especially construction and transportation projects which are "performance projects" of local governments are also greatly impacted. Thus, the future demand of steel is obviously limited.

③ The pressure of the rising cost. Soaring raw material cost reduced the overall industry profits. The cost declination of iron ore, as the main material of steel production, is far less than that of steel price, leading to a sharp increase of cost pressure. At the same time, low concentration of steel and iron industry reduced the bargaining power of buyers and exacerbated the rising of iron ore price.

④ The internal pressure, fierce competition and overcapacity from the whole industry. Compared with major iron and steel countries, the concentration of China's steel industry is obviously low. There are numerous small and medium enterprises in the industry. This produces fierce competition and overcapacity. Taking 2012 as an example, according to global steel production statistical data, released by the World Steel Association in January 22, 2013, Chinese crude steel output was 716 million tons in 2012, accounting for 46.3 % of global steel production; year-on-year growth rate is 3.1 %. In terms of quantities, even the output of China's single province have reached or exceeded the level of some developed countries in Europe and America. With the entry of a large number of small and medium enterprises, the problem of overcapacity will become more serious.

There are several external supporting factors that will force steel company to sharpen its edge, and to apply fine management so as to create value for shareholders continuously. Baosteel has implemented budget management for a long time, and obtained abundant management experience. Basing on above background, Baosteel improved the management system constantly and formed its strategy-oriented budget management mode.

8.1.3 Process of Implementing Budget Control System

① Introduction of Work Flow

Budget target determination. Focusing on value creation and maximization, Baosteel sets a strategic objective of diversification. Its strategic management mainly focuses on three aspects, i.e., sustainable growth, investment return and risk control.

Budget preparation. The budget objectives will break down into KPIs after its determination. Through the KPI system, Baosteel is able to lock on a rough picture of financial statements, and then to work out three budget statements and to finish budget preparation.

Budget execution and budget assessment. The final budget that is issued to each department is not only a constraint on its behavior, but also a standard to evaluate the performance and to measure the strategic goals. Based on the business completion, Baosteel calculates actual KPI and compares it with the set targets, analyzes the deviation, checks the criteria, rewards or punishes the relative persons. At the same time, the extent of completion of strategic goals can be confirmed.

② Introduction of KPI

Baosteel chooses operating income growth rate and capital investment growth rate respectively to measure sustainable growth. The operating income growth rate is to measure the operation of products, and capital investment growth rate is to measure the shareholder's investment.

Baosteel chooses net profit and return on net assets to measure investment return. Net profit is an absolute number and return on net assets is a relative number. These two indicators in combine can help to avoid the manipulation of profit. Baosteel chooses asset-liability ratio and profit-net cash rate to control overall risk. Asset-liability ratio can be used to monitor repayment ability and to avoid the bankruptcy risk; and profit-net cash rate is used to mitigate the liquidity risk.

Above procedures can be shown as Fig. 8.1.

③ Budget System

Baosteel's strategy oriented budget is a system combination of "top-down" and "bottom-up". The "top-down" is the process of decomposition and execution of strategic emphasis. Firstly, according to production and operation of current year, based on company strategy, together with prediction of next year's economy circumstance, market situation and group internal conditions, the company will

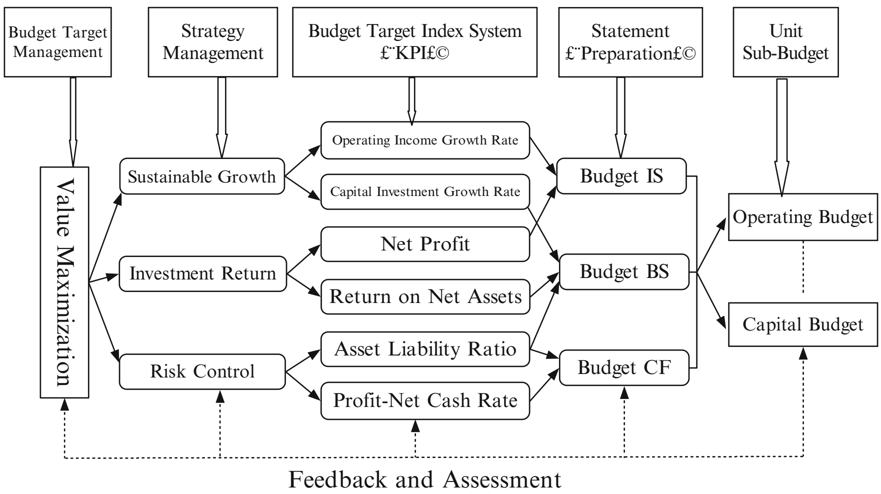

Fig. 8.1 Baosteel's strategy oriented budget

formulate strategy focus on next year and issue them to budget management department. Secondly, according to the determined budget focus, budget management department will formulate preliminary budget reporting, draw up the scheme of budget decomposition and then decompose them to each budget unit.

The "bottom-up" is a process for budget unit to determine specific measures to implement the budget target, and to ensure the realization of company goals. According to the decomposed budget target, together with actual situation, the budget unit will prepare the specific budget, and report to budget management department after checking. The budget management department will summarize sub-budgets comprehensively, and prepare total budget, then report to the enterprise group for approval.

8.1.4 Effects of Implementing Budget Control System

Relying on the implementation of budget control, Baosteel still achieved good profit even under the downturn in the steel industry and became the market leader. According to the Chinese Iron and Steel Industry Association statistics, although all the large and medium-sized iron and steel enterprises realized sales revenue of RMB 3,687.56 billion in total in 2013, but the sales profit rate is only 0.62 %, and it is still in the lowest level of the industrial sectors. However, Baosteel realized the revenue of RMB 190.33 billion and its operating profit was RMB 7.69 billion.

8.2 Case Analysis

Through quantitative index, budget management control mode controls the operation process, evaluates operating results and achieves full range of management, budget, control and assessment. With correct implementation, and effective budget control mode, Baosteel has achieved success in business.

8.2.1 Adapting Budget Control Mode with Features of Organization

Baosteel is the beneficiary of budget control mode, but its effective operation needs certain organizational environment, including external environment, company strategy, and it also requires that the enterprise organization process should adjust in accordance with budget management.

In aspect of external environment and from the analysis of budget control mode, implementation background in the first part of this case, the steel industry is facing poor surviving environment. Enterprises must follow efficient and effective

management mode, and internally seek to maintain competitiveness in the industry. As a perfect internal control mode, budget control mode meets Baosteel's current requirements, and it fully plays its own advantages and provides a great help for the successful operation of Baosteel.

In terms of company strategy, and as a kind of management control mode, budget control mode is to ensure the realization of company strategy, and budget is also prepared based on it. Based on the core values, Baosteel determined sustainable growth, investment return and risk control as three strategy goals. Clear strategy objectives laid a good foundation for the smooth implementation of the budget control mode.

In order to take full use of budget control mode, Baosteel adjusted its organization work flow, and re-designed its business flow in accordance with budget requests. This can be shown by budget preparation procedure. Baosteel carried out a preparation process by combining "top-down" and "bottom-up" (as shown in Fig. 8.1), which effectively solved the problem of budget involvement and control problem, and laid a foundation for budget implementation. From organization's dimension, this interaction of up and down ensured the implementation of group strategy and improved budget involvement effect, which avoided formalism of budget preparation, unpractical budget, and unnoticed budget result. Through above analysis, it is not difficult to find that Baosteel's organizational environment is in line with the requirements of budget control mode. This also guaranteed the final successful implementation of budget control mode in Baosteel.

8.2.2 Connecting Budget Control Mode with Company Strategy

Budget control mode is a kind of management control mode. It quantifies the targets of each department through budget control index, detects and corrects deviation timely in the process of operation to ensure the completion of relevant targets. Budget control is for enterprise strategy. Baosteel implemented strategy-oriented budget control in order to realize connection of budget and strategy, and to ensure achievements of enterprise strategy. Baosteel combined the budget to strategy through budget index system.

The design of Baosteel budget index system is based on the enterprise strategy "to pursue value maximization". The emphases of Baosteel's strategy management are sustainable growth, investment return and risk control. Then, according to the principle of specific, realizable, measurable, accrual and time-bound, six key indexes are selected. Operating income growth rate and capital investment growth rate are used to measure sustainable growth respectively, net profit and return on net assets are used to measure investment return; asset liability ratio and profit- net cash rate are used to control overall risk. As budget key index, these six indexes compose enterprise KPI (as Fig. 8.1 shows) and realize connection of budget and strategy, which lay a foundation for achievement of budget objective.

8.2.3 Combining Budget Control with Evaluation and Incentive Control

The last program of budget control mode is budget assessment, including budget evaluation and budget incentive. Budget evaluation is to assess the result of budget implementation, which includes two aspects: one is to evaluate budget control mode and analyze if the deviation between implementation results and budget caused by defects of budget design itself; the other is to evaluate the executor's performance and to reward or punish the deviation caused by personal reasons. Meanwhile, an effective budget control mode also relies on an incentive system i.e., determination of budget, budget effective implementation, and performance report to provide timely and accurate feedback need incentive system even budget evaluation cannot live without incentive system. Therefore, incentive system runs through the whole process of budget control system. Thus, budget control mode combines budget with evaluation and incentive.

In this case, basing on business completion, Baosteel calculated the actual KPI indexes, compared with the target, checked the budget completion of each department, and analyzed reasons of deviation. It will have punishment or reward if deviation is caused by personal reasons, and there will be budget standard improvement if deviation is caused by incorrect target setting. Simultaneously, Baosteel controlled the effective operation of budget control mode through incentive system. Finally, it achieved combination of budget control with evaluation and incentive.

Through target quantification, Baosteel adjusted the deviation between execution results and budget in order to achieve organization's objectives. The process of adjusting deviation is identical to that of evaluation. Budget control mode adjusts deviation by comparing actual data with target data of key index, and quantified key index is also the evaluation standard; the executors will be rewarded according to their achievements. The combination of budget and evaluation will integrate organization management, reduce operation cost and improve comprehensive strength of the enterprise. Baosteel took fully advantages of budget control mode and achieved business success.

8.3 Case Implications

8.3.1 Considering Organization Environment When Selecting Budget Control Mode

From budget preparation, execution and assessment, budget control mode needs a series of good platform. Budget control environment mainly relates to enterprise strategy, organization structure, responsibility center, human resources and enterprise culture, etc. It requires that the enterprises should have a clear strategy

(including strategic goals and strategic planning), a certain quality of human resources and enterprise culture, especially reasonable organizational structure and responsibility center. Budget control organization structure is the key point of budget control system.

In terms of steel industry, iron-making, steel-making, continuous-casting and rolling-steel are key procedures in production process. In order to meet the needs of the characteristics of modern iron and steel production, establishing a rapid market reaction mechanism, enhancing market competition ability, and implementing production integration have become the innovation trend of iron and steel enterprise production management. Organization's integrated management requires a flat vertical management, and a lean horizontal management. This is consistent with the decentralized management and organization reengineering requirements. It also provides a powerful condition for the effective operation of budget control systems.

According to the degree of authorization, management control modes can be divided into: incentive control mode, evaluation control mode, budget control mode and regulation control mode. Thus the authorization level of budget management control mode is not high. The application of budget management control mode requires enterprise management a certain degree of centralization, and it controls staff behavior through budget index assessment.

In this case, as an iron and steel enterprise, Baosteel has a large number of employees, which requires a certain degree of control to manage staff behavior. Regulation control impairs staff innovation seriously, and the authorization degree of evaluation and incentive control is high. These two methods will incline to cause chaos. However through quantitative index, budget management mode can constraint staff, and at the same time subordinates can be involved in budget preparation with their initiatives. This control mode is suitable for the structure characteristic of Baosteel. After the implementation, Baosteel's excellent operating performance further proved it.

8.3.2 Highlighting Process Control When Constructing Budget Control Mode

As one of management control mode, budget control mode should include target determination, budget preparation, budget execution (budget execution control, budget analysis and budget adjustment), and budget assessment (budget evaluation and budget incentive), etc.

Efficient and effective budget management should stress on process control, timely detection and timely adjustment, so as to avoid the deviation of operation behavior from enterprise target. This would require that an enterprise should pay enough attention to budget implementation and assessment, so as to ensure the realization of organization's objective.

In this case, basing on key index determination, Baosteel prepared budget, and identified the target of each department according to quantified key indexes. In the process of implementing budget, Baosteel realized the process control of budget by comparing the deviation between actual key indexes and target key indexes. Through process control, Baosteel can know the rationality of budget standard and strategy completion in the process of implementing budget, so as to provide a guarantee for operating success.

8.3.3 Emphasizing All Staff Participation When Implementing Budget Control Mode

The design and operation of budget control mode is a complex and comprehensive system which requires that the company management team at all levels should attach great importance to it, that the boss of all units and departments actively should promote and implement it, and that staff at all levels should actively participate in it through cooperation. The implementation of budget control mode is the process of decomposing the overall goals and applying them to each part, so that each unit can make clear the objectives and task of their own. The overall goals of a company cannot be realized without the joint efforts of each department and position. On the contrary, if each unit acts separately and passes over responsibility to others, it will be difficult to achieve the overall target, and company's overall interests will be damaged.

In Baosteel's case, the approach of budget preparation was the combination of "top-down" and "bottom-up". Not only the decision makers were involved, but the executors also gave advice on the preparation. Budget completion and staff interests were closely connected, which would arouse the staff enthusiasm, and they were no longer passive executors. The combination also solved the problem that some budgets lack flexibility.

8.3.4 Understanding the Relationship Between Strategy and Budget

If a strategy wants to have the ability of value creation, it must be able to be translated into financial value drivers. Baosteel broke through the traditional strategic planning, and through strategy emphasis it broke down the group target into budget indexes, making group strategy a successful landing. Baosteel showed its ability of creating value through the strategy perfectly, and at the same time promoted the

implementation of budget. When Implementing budget control, enterprises should be aware of that budget is an integrated management system, and the system has the ability of comprehensive control. Without the support of budget, the strategy of the Group will not be operational. Meanwhile, strategy is the guarantee of sustainable development of the Group, and the budget will be difficult to continue without the base of strategy instruction.

Baosteel's strategy implementation is worthy of being studied: firstly, from the time dimension, Baosteel elaborates the abstract strategy to year, quarter and month, so as to transform long-term goal to short-term; secondly, from the organization dimension, according to the company's organizational structure level, budget target comprises total budget target, responsibility target at all levels, and even the personal budget target; thirdly, from the establishment of index system and according to its own life cycle, budget index system is set up, and index weight is distributed according to strategy emphasis.

8.3.5 Noticing Budget Limitation and Adjusting Management Mode According to the Control Environment

Budget control mode requires the quantification of enterprise goals, but not all can be qualified, so there will be difficulties in budgeting. As a compiled plan in the form of number, the systematicness and accuracy of budget is very high, so there will be a high possibility of budget failure due to poor cost control.

Budget control mode controls staff's behavior by quantifying key indicators, however, for a rigid budget, staff's creativity will be restricted. With the improvement of employee's ability, the requirement of staff's autonomous management will be stronger. Under the condition that the authorization of budget control mode is not very high, the enterprise should improves the quality of the staff gradually and convert to a high level of control mode to adapt the environment.

Because budget control mode achieves target through quantification, so it is lack of flexibility. The strategy is a reflection of the external and internal environment of the enterprise. Under the complex economic environment, the enterprise should adjust the strategy according to external circumstances. Due to lack of flexibility, it is easy to cause business failure.

Therefore, mainly basing on current environment and realistic conditions, Baosteel selects budget control mode. An enterprise shall fully realize its limitation in the application process, and adjusts its own control mode timely according to the changes of internal and external environment.

Chapter 9
Evaluation Control of Tsingtao Brewery Company

9.1 Case Introduction

9.1.1 Basic Information of Tsingtao Brewery Company

As a state-owned enterprise with a hundred years of history in China, Tsingtao Brewery has started to carry out the development strategy of "developing from high point and expanding with low cost" after a series of merger and acquisition since 1996. Thus, it has become a nationwide giant Brewery group with 48 Brewery manufacturing enterprises and 3 malt factories, covering 17 provinces and cities. The production of Tsingtao Brewery is exported to over 70 countries and regions, such as America, Japan, Germany, France, U.K., Italy, Canada, Brazil, Mexico, etc. According to the output ranking in Barth Report (authoritative report in global Brewery industry), Tsingtao Brewery is listed as the sixth largest Brewery manufacturer in the world.

9.1.2 Background of Applying EVA Evaluation Control System

When implementing scale expansion, Tsingtao Brewery neglected its management control. The annual report presents that the main business income was RMB 3.77 billion in 2000, increasing by 54 % year on year; however, due to the great acquisition cost, integration cost and pressure brought by the enterprises purchased, the net operating profit after tax was RMB 0.21 billion in 2000, and the net profit ratio of

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This case is adapted from: The Value Management Mode Based on Economic Value Added, Chunhua Chi, "Economic Management", November, 2003. The case adaptors: Chunhua Chi, Feng Gu, Mengru You.

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its main business was only 2.5 %, and the earnings per share was only RMB 0.11. Obviously, the scale expansion of Tsingtao Brewery did not bring the growth in step with the profit. In 2001, Tsingtao Brewery carried out "Management Board" with the banner of "resource integration", including integrating the organization system, financing, market, brand and capital, refining the organization, establishing the investment corporations to manage the local branches, reduce the information circulation links, and improve the market response speed. However, a series of voluntary adjustment did not fundamentally help Tsingtao Brewery to get rid of the difficulty. In 2001, although the corporate sales revenue and market share went up (the sales volume of the Brewery reached RMB 2.51 million tons, occupying 11 % of the Chinese Brewery market share, with the sales revenue of RMB 5.3 billion), the net profit of the company still grew up slowly. In 2011, the net profit was only RMB 0.103 billion, about 40 % less than the expected net profit of RMB 0.171 billion. EVA of the company in 2000 was RMB −0.08 billion, while EVA in 2001 was expanded to RMB −0.096 billion. Therefore, Tsingtao Brewery did not create income from the viewpoint of the economic significance; instead, it destroyed the shareholder wealth. Under such circumstance, Tsingtao Brewery intended to build evaluation control system centered on EVA, so as to improve its profit status.

9.1.3 Establishing EVA Evaluation Control System Mode and Its Application Process

① Adjusting the Strategic Objectives and Establishing the Management Control Mode

Strategic planning is the starting point of the management control. When Tsingtao Brewery realized that it was infeasible to only focus on expansion, they promptly adjusted the strategic objectives, and transferred to improving the shareholder value from original strategic objectives of merger and expansion. It emphasizes that the strategic planning is how to apply the limited cost resource, adjust the operational strategy matching with the cost resource, establish "bearable business mode" of the enterprise, and form strategic planning on both functional and business tier for 3–5 years, and financial planning objectives. After the strategic planning is clarified, it is necessary to select proper management control means to ensure the realization of the strategic objectives. Simply speaking, what EVA balances, is the balance between the capital gain and capital cost. The most important feature is to redefine the profit of the company from the viewpoint of the shareholder, and consider the cost of all capital the company input (including the equity capital). Therefore, compared with the traditional accounting profit orientation index, it can reflect the strategic objectives of the corporate shareholder value more faithfully. Tsingtao Brewery selects EVA, and establishes the management control system centered on it.

② Carrying Out Process Reengineering and Establish Value Platform
The pyramid structure of the original head quarter, business division and subsidiaries of Tsingtao Brewery cannot adapt to the constantly increasing scale of the enterprise. Therefore, Tsingtao Brewery has proceeded with business process reengineering and rebuilt the organization structure based on the establishment of EVA. It has started to implement the management mechanism of the regional business division, and founded eight business divisions in succession, and unified the production-supply-marketing, market management and financial computation, and also established planning centers, marketing centers and profit centers of Tsingtao Brewery in the regional markets. In 2002, the company established a logistics company together with Shenzhen Commercial Bureau, so as to improve the logistics management level and reduce the logistics cost.

③ Integrating the Financial System and Provide Decision-Making Support
It replaces the financial function based on the requirements of EVA value management mode, and integrates the current financial system. Tsingtao Brewery requires that the whole financial department should compile the external reporting based on the related accounting regulations, and also compiles internal reporting based on EVA, and applies them to evaluate the performance. In Addition, it takes advantage of EVA evaluation control system to play the function of planning formulation and decision-making support.

④ Training the Enterprise Staffs and Reforming the Annual Salary System
As an evaluation management control system, EVA requires the enterprise operators to achieve high quality and take initiative to regard the evaluation index as the guidance to carry out the operational management activities. Meanwhile, it requires the enterprise staffs to clarify and acknowledge EVA management control system operation mode so as to achieve sound organization environment and corporate culture favorable for the operation of the management control system. Therefore, prior to initiating EVA control system officially, the senior managers, cadres and staffs of the company have been provided training. The training content includes the connotation of EVA, computation of EVA, interpretation of EVA results, salary plan related to EVA, etc. Meanwhile, it also reforms the original annual salary system, and establishes EVA incentive mechanism. This mechanism adopts the superincumbent approach, i.e., it is carried out in the manager layer of Tsingtao Brewery Company first, and then introduced to the staffs gradually.

9.1.4 Effects of Implementing Evaluation Control System

Establishing and implementing the value management mode based on EVA is the secondary management revolution conducted by Tsingtao Brewery. Although the revolution was continuously carried out, the annual report of 2002 reflected the performance improvement brought by the secondary management revolution in 2002, the sales volume of the Brewery reached 2.99 million tons, which was

increased by 21 % year on year; the domestic market share was increased to 12.5 % from 11 %; the main business income was RMB 6.94 billion, which was increased by 31 % year on year; the cost and expense were effectively controlled, and the main business cost was increased by only 28 % year on year; the net profit of RMB 0.23 billion, which was increased by 124 % year on year; the earnings per share was RMB 0.23, and the cash flow generated from the operation activity per share even reached RMB 1.11. This company planned to issue special dividend RMB 0.06 per share (including tax) at the same time of issuing RMB 0.16 per share (including tax) in 2002. The substantial increasing of the product output has already become a bright spot in 2002. It exported 64,000,000 l of Brewery in 2002, and obtained 40,480,000 dollars, which was increased by 110 % and 104 % respectively. Certainly, the most importance is that EVA of Tsingtao Brewery in 2002 was transformed to a positive number from a negative number, which indicates that the wealth of the shareholders was increased.

9.2 Case Analysis

9.2.1 Taking Organization Process Reengineering as the Premise of Implementing Evaluation Control System

The enterprise that applies the evaluation control system is required to establish a sound organization structure according with the strategic demands, and meanwhile, it should reasonably authorize the rights, clarify the division of responsibility center, and match the responsibility with the rights. Besides, the enterprise should decompose the strategic objectives through the organization structure, carry them out, and make the managers of each level achieve the clear and transparent tasks and responsibilities. The original organization structure of Tsingtao Brewery is the pyramid structure of the head office, business division and subsidiary. The pyramid structure emphasizes the hierarchy organization, and establishes the line and staff organization structure form. The increasing expansion of the corporate scale gives rise to ineffective communication between supervisors and subordinates, information distortion, etc. Furthermore, the pyramid organization structure is also one of the factors leading to the current crisis of Tsingtao Brewery.

Therefore, to give full play to the effect of the evaluation control system based on EVA, first of all, it is necessary to take the organization process reengineering as the premise. The ultimate objective of the process reengineering is to establish Flat Organizational Structure adapting to EVA evaluation control system, and determine the examination center of EVA, so as to create a platform for the implementation of EVA value management. Determining EVA examination center must fully authorize the right to the managers of the center, and enable them to have the decision-making

right of capital expenditure and profit control. Certainly, the administering authority of the company should retain the supervision right of the decision making in EVA examination center. Therefore, Tsingtao Brewery has conducted business process reengineering surrounding the creation of EVA, and rebuilt the organization structure. It has already started to implement the management mechanism of the regional business division, and established eight business divisions in succession, unified the production-supply-marketing, market management, and financial accounting, and also founded the planning center, marketing center and profit center of Tsingtao Brewery in the regional markets.

9.2.2 Measuring the Performance of the Management Layer Through EVA as the Core Index

As the enterprise scale is expanded continuously and the shareholder wealth decreased remarkably, Tsingtao Brewery repositions the strategic planning, and relocates the corporate value on the primary strategic objective, takes the value creation as the orientation, selects EVA to establish the management control system, and balances the performance of the management layer by taking EVA as the core index. Compared with the traditional performance evaluation index, i.e., accounting profit index, the advantage of EVA index lies in the following aspects.

① It modifies the errors and distortion resulting from the current accounting criterion through the accounting adjustment, such as R&D expenditure, marketing expense, and staff training expense. Obviously, from the long term, it can create value for the enterprise. To pursue the increasing of the short-term profit, the operator will input corporate resource in expanding the product output and sales volume, but neglect the strategic input on the new product development, brand construction strengthening, etc. However, EVA index takes the amortization of the research and development expense and the adjustment of the financial expense into account, which encourages the enterprise to transfer the strategic emphasis to the project of accelerating the long-term development of the enterprise, such as developing new products, strengthening the brand construction, etc., with the purpose of preventing the emergence of the short-term behavior. Tsingtao Brewery selects EVA index as the core and standard of the corporate strategic planning. It is necessary to give up the operation business that destroys the shareholder value even though it can bring positive sales revenue and accounting profit.

② It introduces the capital cost idea into the performance evaluation system and considers both the cost of the liability capital and the equity capital. Measuring the equity capital shows the lowest return rate of the risk constraint required by the shareholder. Shareholder's value can only be created if the profit of the used capital is exceeded.

Therefore, EVA evaluation control system serves the strategic orientation of Tsingtao Brewery value creation. It takes EVA index as the core, and unifies the evaluation standards with the corporate objective, which is favorable for measuring the performance of the management layer clearly, and thus improving the effectiveness of the operation strategy and decision making.

9.2.3 Promoting Enterprise Value Creativity by Taking Budget Management as the Guarantee

The budget management of Tsingtao Brewery is value creation oriented. It combines the budgeting with the strategic planning and resource distribution closely, so as to promote the value creativity of the enterprise. Besides, it adopts the budget management based on EVA. When budgeting, Tsingtao Brewery adopts EVA analysis method to sort out the value driving factor, so as to determine the key factor that has the greatest impact on the enterprise, and subdivides the enterprise business range and organization structure, and verifies the value driving factor and evaluation index controlled by each unit, and puts the related responsible persons in the correct place. In addition, the scientific and rational development strategy is favorable for improving the foresight of the budgeting. According to the strategic adjustment and planning, Tsingtao Brewery takes several factors into account i.e., the whole operation risk, industry development status, management layer, market, etc. On that basis, it decomposes the corporate strategy into key elements, key performance index and various action plans, and then formulates budget, and ensures that the budget is in accordance with the strategic objective of the company. It applies EVA to index the strategic objective, and makes the activities of each cost center, investment center and profit center of the enterprise to focus on the objective of the capital cost and value appreciation.

Meanwhile, Tsingtao Brewery regards EVA evaluation control system as the main body, and establishes evaluation hierarchy system in accordance with the budget organization structure. For instance, on the sales line of the marketing center, it establishes the senior management layer, marketing center, provincial unit, urban district, second-level region, 6-level budgeting organization and performance evaluation organization, and arranges CEO, deputy CEO, provincial-level manger, urban regional manager, second-level regional manger and business representative as the first principals of 6-level management organization. With regard to the production line of the manufacture center, it forms 6-level budgeting organization and achievement evaluation organization of top management layer, manufacture center, factory, workshop, production section and production team, and arranges the first principals of 6-level management organization from top to the bottom. At the same time of setting the budgeting right for the internal budget responsibility center of each level, it endows corresponding achievement evaluation rights, and forms the evaluation from the operator, manager to the staff step by step, and comprehensively reflects the achievement evaluation organization of the responsibility center of each level.

9.2.4 Establishing Annual Salary System of the Management Layer Based on EVA System

The core opinion of the evaluation control system based on EVA is to relate the management salary with EVA index, and make the operator's objective conform to the shareholder's. According to the characteristics of EVA index, Tsingtao Brewery reforms the annual salary system so as to determine the management reward. In the past, Tsingtao Brewery carried out the annual salary system towards the managers (general managers or factory directors of each unit subordinated to the joint-stock company, and part-time deputy general manager of the group). The aim for implementing this system is to retain and encourage the talents. However, it adopts the assessment criteria with the profit as the center, and neglects the cost of the capital, which causes that the managers neglect the return rate of the investment and the risk of the investment is increased. Therefore, this annual salary system lacks fairness. However, the incentive system designed with EVA as the center can make up for the ambiguity of the annual salary system of Tsingtao Brewery, as the introduction of the capital cost concept enables the managers to use the capital reasonably, and thus improve the utilization efficiency of the capital.

9.3 Case Implications

9.3.1 Selecting Evaluation Control System Mode Scientifically

At present, there are mainly four management control modes in China, i.e., regulation control system, budget control system, evaluation control system, and incentive control system. Each management control modes have their own characteristics. To select the proper management control mode scientifically, on one hand, it is necessary to understand the connotation, characteristics, applicable environment, and application process of different management control modes; on the other hand, it requires the enterprise to carry out correct analysis on the strategic environment, formulate proper strategic objective, conduct proper strategic planning, and make the selected management control mode conform to the enterprise according to the environment and status of the enterprise, so that it can reach the control objective, complete the strategic objective, and promote the sound development of the enterprise. With regard to the evaluation control system mode, the core feature is to emphasize on the control of objectives instead of the control of the process, and it mainly focus on the realization of the result. It authorizes great rights to each department. The objective of the control lies in developing the staffs' potential ability, highlighting the evaluation result and encouraging the staff to keep forging ahead constantly.

Tsingtao Brewery analyzes the environment of the company and judges the potential crisis at first. It finds that the increasing corporate scale does not bring

corresponding increasing benefit. The rapid expansion leads to the generation of "big company disease". Therefore, it is necessary to transform the strategic objective from outward expansion to the internal management control system construction. Aiming at the large group organization system, constant decreasing of the profit and inconsistent corporate evaluation standards, it is feasible to select the evaluation control system, to take EVA as the only index of the achievement evaluation, and to focus on the realization of the objective and result, which greatly improves the value creation ability of the company and accelerates the better development of Tsingtao Brewery.

9.3.2 Improving the Operation Environment of the Evaluation Control System Mode

The normal operation of the management control mode requires certain environment as the basis. It can only perform proper effect if the management control mode is operated in the proper environment. Separated from the certain operation environment, any management control mode seems as water without a source and a tree without roots. Therefore, after selecting the proper management control mode, the enterprise should reform the internal condition and optimize the operation environment required by the mode according to the characteristics and applicable conditions. With regard to the evaluation control system, the operation environment of the evaluation control system mode requires the enterprise to have definite strategic objective, good corporate culture and sound organization, etc.

In the case of Tsingtao Brewery, we can see that, firstly, Tsingtao Brewery clarifies the strategic objective of the enterprise, i.e., transforming from the original strategy of "develop from the high point and expand with low cost" to the reform of the corporate management control system, which unifies the corporate strategic objective as creating EVA. Secondly, the reform proposal adopts the performance evaluation control system based on EVA. One of the key factors for Tsingtao Brewery to successfully carry out the evaluation control system is that it had formed good organizational culture before implementing the reform, i.e., Tsingtao Brewery created organizational culture of placing the value creation in all management activities. Such organizational culture enables all staffs of Tsingtao Brewery to realize that the performance assessment of the enterprise should be transformed to be based on the economic profit from the accounting profit. Besides, the center of the corporate management should be transformed to the capital gain maximization from the profit maximization. The staffs of Tsingtao Brewery firstly accept such organizational culture, so that they can acknowledge the performance evaluation control system based on EVA. Finally, Tsingtao Brewery conducts the organization process reengineering and creates a flat organization structure suitable for EVA performance evaluation control system, and this ensures the effective operation of this management control mode.

9.3.3 Attaching Importance to the Selection and Actual Application of the Evaluation Method

There are mainly three kinds of methods of the evaluation control system, i.e., single evaluation method, comprehensive evaluation method and multi-perspective balanced evaluation method. We should clarify that, different evaluation method is applicable to different corporation and organization types. The enterprise should select different evaluation methods according to their own organization types. For instance, EVA performance evaluation system is suitable for assessing the business units as EVA centers, such as head quarter of the assessment, subsidiaries, branches, independent business division, project team, etc. However, the business units, such as human resource department and D&R department, are not suitable for serving as EVA center, and it is not suitable for them to adopt EVA performance evaluation method. The balanced score card of the multi-perspective balanced evaluation method is applicable to the enterprises that face great competitive pressure and take the objective and strategy as the orientation, or with the leadership system, or relatively high cost management level. When we select the evaluation methods, we should fully consider several conditions of the company, such as strategic objective, organizational structure, industrial characteristics, organizational culture, etc. According to these conditions, we can judge whether the evaluation method is suitable for the company or not. In this case, the main crisis of Tsingtao Brewery is that the constant decreasing of EVA value is destroying the wealth of the corporate owner. However, in face of such situation, how to create EVA has become the primary problem of Tsingtao Brewery. Therefore, Tsingtao Brewery selects the management control mode with EVA as the core.

It should also be noticed that, it is necessary to flexibly apply the evaluation method and improve the ranking method according to the circumstance. It requires the enterprise to proceed with practice according to its own situation and characteristics, as well as the actual situation, and not to copy other enterprises blindly. In this case, the accurate calculation of EVA value has close relation with the correct accounting adjustment. However, at present, the accounting adjustment of EVA is complex. Tsingtao Brewery widely refers to the standards of other enterprises in the same industry to calculate its proper EVA value.

9.3.4 Establishing Supervision Mechanism and Ensuring the Operation of the Evaluation Control System

As one of the four major management control modes, evaluation control system also has some deficiencies, such as lacking process control, and its relatively great man-made randomness. Therefore, to ensure the effective operation of the evaluation control system, we should establish a sound supervision mechanism. In principle, the board of directors takes charge of the sound establishment and effective

implementation of the managing and controlling. The board of supervisors supervises the establishment of the board of directors and the implementation of the management control. The management layer takes charge of organizing and guiding the daily operation of the corporation management. Meanwhile, the enterprise should establish specialized agencies or assign proper institutions to specifically take charge of organizing and coordinating the establishment, implementation and daily work of the management control. Tsingtao Brewery should still pay attention to strengthening this point because the supervision is only limited to the obvious public affairs, such as the corporate finance. It lacks effective supervision on the corporate management control. Therefore, Tsingtao Brewery should firstly strengthen the role of the board of supervisors to give an effective supervision. Although the board of directors has certain supervision function, it mostly performs the decision-making function as the decision-making and right center of the enterprise from the perspective of organization setting and function. Thus, to strengthen the function of the board of the supervisors and give full play to the supervision right can effectively guarantee the operation of the management control system.

Chapter 10
Incentive Control of Shanghai Jahwa United Company

10.1 Case Introduction

10.1.1 Basic Information of Shanghai Jahwa United Company

Shanghai Jahwa United Company (referred to as Shanghai Jahwa) is one of the largest local cosmetics companies in China, and was the first company to be listed in domestic daily cosmetics industry. The Company carried out all-round competition with Multi-National Corporations (MNC). It was founded in 1898 and was developed from the original Shanghai Jahwa Co., Ltd. Shanghai Jahwa consists of the original Shanghai Jahwa (Group) Co., Ltd., the Shangshi Daily Chemical Holdings Limited, Shanghai Industrial Investment (Group) Co., Ltd., Fujian Hengan (Group) Co., Ltd., Shanghai Guang Hong (Group) Company and Shanghai Hui Sheng Industrial Co., Ltd.. For more than 100 years, Shanghai Jahwa has always followed the principle of "delicate and dedicated", which is also Shanghai Jahwa's commitment forever. Shanghai Jahwa committed to build a Chinese fashion brand and made a great contribution to optimizing and upgrading consumer goods industry at a new starting point and to make Shanghai the fashion capital of the world. In March 2001, Shanghai Jahwa was listed on the Shanghai stock exchange. The company was initially issued 270,000,000 shares, of which Shanghai City SASAC (State-owned Assets Supervision and Administration Commission) directly and indirectly controlled 61.47 %. In December 2011, Shanghai Jahwa completed its overall restructuring; Pingan Group invested RMB 5,109,000,000.00 to acquire all the shares of Shanghai Jahwa. Shanghai Jahwa transformed from a state-owned company into a private company.

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10.1.2 Motivation for Implementing Stock Option Incentive

Shanghai Jahwa implemented stock option incentive plans because of two main reasons:

① Attracting Talents to Build the Company's Core Team
Shanghai Jahwa is a daily cosmetics company and mainly produces cosmetics. Because of the constraints of its salary system, the loss of talent was a serious problem in Shanghai Jahwa. In order to keep motivating employees, reduce the loss of talent, maintain its strategic coherence and create long-term benefits for the company, Shanghai Jahwa implemented the stock option incentive plan.

② Improving Performance to Promote Long-term Developments of the Company
During 2003–2005, the operation situation of Shanghai Jahwa was not optimistic. Its income, net profit and operating cash flow were decreased greatly, which would undoubtedly weaken its competitive position in the industry. In order to fully mobilize the employees' enthusiasm, enhance the performance, improve its international competitiveness, and realize long-term development, Shanghai Jahwa implemented the stock option incentive plan.

10.1.3 Process of Implementing Stock Option Incentive

As early as in September 2006, Shanghai Jahwa published its first set of formal stock option incentive plan and put forward to issue not more than 16,000,000 shares directionally to the incentive objects. But as the SASAC's requirements that related to stock option incentive had not yet been introduced, the plan was not implemented as expected. In March 2007, Shanghai Jahwa then launched the second set of stock option incentive plan. The company planned to extract 25 % of annual increment of the audited profit before tax as the incentive fund, which was used for the purchase of circulation stocks in order to motivate managers. But this plan was halted again before it was submitted to the general meeting of shareholders. After several setbacks and multi-level communication with the CSRC and SASAC, Shanghai Jahwa finally launched the first phase of stock option incentive and granted stocks of not more than 5,600,000 total shares in 2008, from which they reserved 300,000 shares. These stocks were ordinary stocks that the company issues to the incentive objects directionally. It was forecasted that the market price would be RMB 15.21 per share and the grant price be RMB 8.94 per share. The incentive objects included the president, the general manager and other senior management personnel and the core technical staff and salesmen. This means that the managers who were included in the plan would have to spend at least RMB 270,000.00 in cash to buy the directional issued shares. It was a 5-year stock option incentive plan, of

which the first 2 years belonged to the lock-up period and the other 3 years belonged to the unlock period. The 25 % of stocks could be sold each year during the unlocked period. If it goes well, the 175 middle-level technical and administrative staff would gain the benefits of 30,000 shares per capita.

In order to further mobilize the enthusiasm of management personnel and core technical staff and to further enhance the company's core competitiveness, Shanghai Jahwa launched the second phase of stock option incentive plan in May 2012.

10.1.4 Effects of Implementing Stock Option Incentive

After the implementation of the stock option incentive, there was an increase of 22 managers, 27 researchers, 85 salesmen, 16 managers in charge of production in Shanghai Jahwa. At the same time, the financial performance of company was improved as compared with the conditions before the implementation of stock option incentive plan. Revenue, net profit and cash flow of Shanghai Jahwa during 2008–2011 were highly improved, which attracted talents and improved the performance of the company to some extent.

10.2 Case Analysis

10.2.1 Choice of Mode of Incentive Control System

The incentive control system is one kind of modes of management control systems, whose basic characteristic is interest-oriented control. It can coordinate the goals of stakeholders by controlling manager's behavior to create greater value for a company. It is at the highest level of management control systems that have four modes. The authorization of the incentive control system is at the highest level, so its demand for control environment is also the highest. Currently very few companies in China directly use the incentive control mode that requires companies to have a high level of management and a healthy environment for economy. The mode applies to listed corporations, high-tech companies and private companies. In addition, as most state-owned companies have concentrated ownership, it's very difficult for their management to adapt to the market; and top manager's appointment and flow are subject to administrative intervention, therefore they must balance the extent of incentives and constraints when they motivate managers.

In March 2001, Shanghai Jahwa was listed on the Shanghai stock exchange. As one of the eight listed corporations in daily cosmetics industry, Shanghai Jahwa has a relatively perfect modern enterprise system, and its management is more consistent

with the laws of market. The stocks of Shanghai Jahwa are in circulation but can't be repurchased. It has dispersed ownership, diversified property rights and non state-owned capital. Shanghai Jahwa has a good external supervision system and can receive constraints of the information disclosure. Thus, the marketization degree of Shanghai Jahwa is obvious and it is suitable to use the incentive control system to realize the owners' control of managers.

There are many kinds of incentive control modes, including the annual salary system, stock option incentive, bonus incentive and sharing plan, etc. Each kind of incentive modes has different incentive effects, so a company should select suitable incentive mode according to its own company scale, industry, stage of development, company culture and other specific characteristics and external economic environment. Stock option incentive is that a modern joint-stock company uses its stocks as the subjects to have a long-time incentive to directors, supervisors, senior managers and other managers. The stock incentive mode includes restricted stocks and stock options and others that are allowed by the laws and regulations. Listed Corporations should be guided by the stock option incentive mechanism and choose the appropriate stock option incentive mode according to the motivation of the implementation of stock option incentive and the characteristics of the industry and the company itself. Restricted stocks are more suitable for companies in the stage of maturity that mostly have abundant funds, lower payment risks and higher profits. Those companies in the stage of growth are more suitable for stock options, because they have a large room for development. A given company should determine the appropriate stock option incentive mode according to its own development stage.

Many companies in China adopt stock options in the implementation of share incentive plans. However, Shanghai Jahwa used restricted stocks in the two phases of stock option incentive plans. Because Shanghai Jahwa has a business history for more than 100 years, even though the company is facing fierce market competition, the prospect of its industry is good and the company has developed stably and is in the leading position for the domestic daily cosmetics industry. Therefore, the company considered its own conditions and used the restricted stock option incentive mode both before and after the restructuring.

10.2.2 Grant Range of Incentive Objects

The overall goal of the incentive control system as the whole is consistent with the objective of management control, which is in the pursuit of efficiency and effectiveness. The specific objective of incentive control is to create greater value for organizations or companies through coordinating the interests and goals of managers and owners. Therefore, the objects of the incentive control are managers, especially senior managers. The incentive control is to coordinate manager's personal goals and owners goals and adjust strategies and objectives timely to create greater value for the company as whole according to the ever-changing social and economic

environment. A company should determine the appropriate objects of incentive control according to the motivation and its own actual situation.

Shanghai Jahwa's original intention of the implementation of stock option incentive is to attract and retain talents, so the objects of stock option incentive are mainly the senior managers and the company's core technical staff. Shanghai Jahwa granted 175 employees with stock options during its first phase of stock option incentive that accounted for 17.16 % of the total staff, of which the middle-level managers, salesmen and technical staff accounted for 96 % of the incentive objects. A number of the objects of the second phase of stock option incentive were totally 395 persons and accounted for 37.8 % of the total number of employees. Three hundred and eighty eight persons were the company's middle-level managers and core technical staff among them and accounted for 98.23 % of the incentive objects.

The above data showed that the range of Shanghai Jahwa's first phase of stock option incentive was smaller as compared to the second phase, because at that time it was still the SASAC holding company. If the range of stock option incentive was larger, then there was the suspicion of conveying interests to the managers from the company, which was contrary to the goal of keeping and improving value of the state-owned property. But the small granted scope of stock option incentive has limited effects to motivate managers. Therefore, in the second phase of the stock option incentive plan, Shanghai Jahwa expanded the scope of incentive objects and made them contribute to the long-term development of the company.

10.2.3 Settings of Shareholding Ratio of Incentive Objects

Incentive control system is not an isolated project but it involves all aspects of the company, and generally speaking it can be said to be a systems engineering of enterprise management. The design of incentive control system should follow the principle of clarity, participation and stratification. The principle of clarity is that the goal of incentive control system must clearly reflect company's financial objectives and strategies. The principle of participation is that all managers who want to participate in the activities of formulating the incentive mechanism are able to participate in the process of formulating incentive mechanism. The principle of stratification is that the company should design different incentive goals and incentive frameworks according to different incentive objects, such as different incentive modes for the top managers and the general managers, so as to guarantee the directionality of the incentive mechanism and the maximum of utility.

The motivation of Shanghai Jahwa's stock option incentive plan is to attract talents. This means to attract and retain the middle-level managers and the core technical staffs. So the design of Shanghai Jahwa's stock option incentive plan has always regarded "talent" as the leading factor. The range of incentive objects mainly focuses on the middle managers and the core technical staffs. The benefit of this system is that, the company granted higher ratio of shareholding for the above incentive objects. The first phase of stock option incentive plan directionally issued 5,600,000

shares to the incentive objects, the ratio of seven senior managers shareholding was only 10.71 %; corresponding to that of middle managers and core salesmen as it was 83.93 %. The number of granted stocks in the second phase of stock option incentive plan was not more than 25,405,000 shares and accounted for 6.01 % of the total ordinary share capital. The ratio of seven senior managers shareholding was only 10.08 %, while the proportion of shareholding of middle-level managers was 22.93 % and the proportion of shareholding of core technical staffs was 66.99 %.

The above data showed that Shanghai Jahwa granted a large proportion of stocks for the middle-level managers and core technical staffs in the second phases of stock option incentive plan. Especially on the proportion of shareholding of the core technical staffs in the second phase accounted for more than half of the total proportion of shares. This showed that in the implementation of stock option incentive plan, Shanghai Jahwa tightly followed its initial implementation motivation, which reflected the principle of clarity. The granted objects of incentive control included the company's top managers and middle-level managers and the core technical staffs. But they had different proportions of shareholding, which reflects the principle of participation and stratification of incentive control system. It is conducive not only to improve work enthusiasm and innovation of the middle managers and core technical staffs, increase their enthusiasm for work and reduce loss of talents, but also to attract outside talents to join the company and add new vitality to the development of company. As a result, it is useful to facilitate the company to achieve its goals of production and operation and maximize the enterprise value.

10.2.4 Design of Evaluation Index

Performance evaluation is the important basis of incentive control system. The incentive and punishment for managers requires the performance evaluation. So a company must design a reasonable performance evaluation system to play a role of incentive control system. It is a very complicated problem on how to select and construct the performance evaluation index, the evaluation standards, innovative and effective evaluation method.

With reference to the selection of evaluation indexes, performance evaluation indexes for managers consist of stock price, net profit, rate of return on net assets and EVA currently. But the stock price index linking with the manager's compensation can reflect the future value of the company and the direct demands of shareholders for interests. The stock price is affected by many factors, such as the efficiency of capital market and noise traders, so the stock price used as the performance evaluation criteria will undoubtedly increase the risk that the managers have to undertake. But also linking net profit, rate of return on net assets with the managers' compensation can reflect the previous operation results of managers. These indexes are easy to be influenced by the accounting policies and management manipulations. Besides, the current earnings often have a certain lag to reflect production and operation status of managers. The index of EVA tries to combine the

advantages of accounting indexes with market indexes and its usefulness needs further test in China, because each kind of performance evaluation index has its advantages and disadvantages, it is very necessary to select a set of comprehensive performance evaluation system to reflect the performance of the managers.

To overcome the shortcomings on the first phase where rate of return on net assets was the only evaluation index, then the evaluation index of the second phase applied a dual management performance evaluation indexes so as to better reflect the company's performance. At the same time, the incentive plan clearly pointed out to adopt interim results tracking, year-end assessment summary to evaluate the directors, senior managers, middle-level managers once a year. The evaluation grades are divided into five levels that include A+, A, B, C and D. If the annual evaluation results of an incentive object is the C (qualified) and above C, the incentive object can unlock the restricted stocks each year. If the evaluation result of an incentive object is the D (unqualified), the company will repurchase the granted stocks based on the granted price and logout the shares in accordance with the relevant provisions of the stock option incentive plan. If the evaluation results of the incentive object are for C (qualified) during the continuous 2 years, then it is viewed as unqualified, the company will repurchase the granted stocks based on the granted price and logout the shares in accordance with the relevant provisions of the stock option incentive plan. The hierarchical evaluation method is a trial method of performance evaluation for managers that helps to improve manager's enthusiasm to improve company performance and avoid slacking phenomenon.

With respect to the second phase of stock option incentive plan, Shanghai Jahwa granted incentive objects restricted stocks to unlock for three times. In the three consecutives fiscal years of 2012, 2013 and 2014, there is an annual performance evaluation and unlocking the stocks in each accounting year. The annual performance evaluation goals are showed in Table 10.1.

In the second phase of stock option incentive, Shanghai Jahwa used dual indexes (i.e., the weighted average rate of return on net assets and net profit) as incentive performance evaluation indexes for the managers, which is conducive to reflect the operating results of the managers in the past. But there is a certain lag in reflecting

Table 10.1 Performance goals of stock incentive of Shanghai Jahwa

Unlock period	Performance evaluation goals: The weighted average rate of return on net assets	Performance evaluation goals: Net profit
First unlock period	The weighted average rate of return on net assets of 2012 is not less than 18 %	In the 2011 annual net profit for reference, the 2012 growth rate of net profit is not less than 25 %
Second unlock period	The weighted average rate of return on net assets of 2013 is not less than 18 %	In the 2011 annual net profit for reference, the 2013 growth rate of net profit is not less than 56 %
Third unlock period	The weighted average rate of return on net assets of 2014 is not less than 18 %	In the 2011 annual net profit for reference, the 2014 growth rate of net profit is not less than 95 %

the current operating results of the managers. The company adopted a hierarchical evaluation method to evaluate the incentive objects and set five evaluation grades. Only those incentive objects who comply with the provisions of the conditions of incentive goals would have access to unlock the restricted stocks. Otherwise the company should repurchase the stocks that should be unlocked and logout them. This evaluation method is helpful to improve the incentive objects' consciousness of crisis, to combine their own interests with the overall and long-term interests of the company and to promote the smooth implementation of the stock option incentive plan as well as the continuous improvement of the company's performance.

10.2.5 Evaluation System of Incentive Control System

The evaluation system of company incentive control is an important part of the operation environment of company incentive control system. The company should establish and perfect the internal control evaluation system and methods of the incentive control system. The internal control evaluation system is one of the very important supporting systems of incentive control system and makes the designer observe the implementation effects and the improvement direction of the company from the standpoint of outsiders. The company should have the courage to admit shortcomings that are exposed as implementation problems and defects in order to improve and perfect persistently.

According to the calculation, the total cost of the restricted stocks granted for the incentive objects in Shanghai Jahwa was RMB 169,959,500.00. Because the exercise period was short in the second phase of stock option incentive plan, nearly the cost of RMB 170,000,000.00 of stock option incentive could not be amortized over a longer period. According to estimates, the amortized cost of stock option incentive of Shanghai Jahwa in the first 12 months was more than RMB 100,000,000.00. The stock option incentive cost would not result in the company's operating performance loss, but the huge amortized cost pushed great pressure to the company's operating performance.

The evaluation system of Shanghai Jahwa should react to the problems appeared in executing incentive control system. Because the exercise period was short in the second phase of stock option incentive plan and the cost of amortization was too high. The evaluation system should find out the solutions. According to the characteristics of stock option incentive, the company should use the method of uniform batches during the exercise period of validity, which could evenly amortize exercise cost. The right of exercise automatically disappears beyond the exercise period of validity and those holders could not trace back to exercise. A reasonable time limitation of exercise can make the managers pay more attention to the long-term development of the company and converge their interests with that of the whole company. If the exercise period of stock option incentive is very short, then the cost stock option incentive will be amortized in a very short period, which will cause enormous pressure to the company's financial situation and will not be conducive to realize the

goals of stock option incentive. Therefore, appropriate evaluation system can reduce the pressure caused by the unreasonable exercise period.

10.3 Case Implications

Although the design of the stock option incentive plan of Shanghai Jahwa is not reasonable, but there are also some advantages that worth learning for other companies. The proper use of incentive control system has a profound significance and long-term effects for a company's operation and development. According to the process of the stock option incentive of Shanghai Jahwa, therefore, we draw the following implications for effectively implementing the incentive control system and avoiding its disadvantages:

10.3.1 Selecting Management Control System Appropriately

In our country, the framework of internal management control system model consists of system control system, budget control system, evaluation control system and incentive control system. Each kind of internal management control system model has its advantages, disadvantages and scope of application. The company should choose proper management control system according to the external economic environment and its own conditions. The incentive control system will then link the benefit of owners with the interest of managers and be able to regulate manager's behavior through the benefit restraint mechanism. According to the ever-changing environment, managers can adjust the objectives and strategies timely to timely and ensure to realize the goal of maximizing the company value. But specific goals are often not clear for those companies which implement incentive control system. Incentive control system requires higher quality of company culture and management. If the company has got a higher management level and good environment of the economy, it will easily to choose incentive control system.

The company can take effective control when it chooses a suitable internal management control system. According to the change of external environment and internal environment, Shanghai Jahwa finally chose the incentive control system mode. In the aspect of the external environment, the SFC promulgated the "*Stock option incentive Management Regulation for Listed Corporations (pilot version)*" in 2006, which regulates stock option incentive of listed corporations. Then the 1–3 supporting memorandum were introduced for instructing the details. The SASAC and the Ministry of Finance jointly issued the "*The Pilot Regulation of Stock option incentive Implementation in the State-owned Listed Corporation (China)*" in 2006. The above two regulations put forward corresponding requirements for the stock option incentive of state holding listed corporations, which also provided the basis for the implementation of stock option incentive plans for listed corporations. In the

aspect of the change of internal environment, its modern enterprise system become more and more perfect and the degree of marketization is becoming more and more obvious since listed in March 2001. Then Shanghai Jahwa has conditions that incentive control system mode requires. Because of the constraints of salary system, the company lost key personnel and its profits decreased greatly during the financial years ending 2003–2005. In order to continue to motivate employees and to promote the long-term development of company, Shanghai Jahwa finally implemented the stock option incentive plan and has made great achievements, not only to improve the operating performance, but also to attract a large number of talents.

10.3.2 Choosing Incentive Methods Appropriately

A company should choose the most effective incentive mode according to its characteristics and that of its industry. The studies show that only by selecting the appropriate incentive mode, then the company will make full use of the effects of incentive control system and enable managers to play their potentials, and then will turn a negative attitude into a positive attitude and effectively maintains work efficiency. It will also help to attract the talented and the needed personnel and make them work for the company in a long period time, thus solve the complex economic relationship and contradiction in the enterprise operation effectively. In the aspect of control level, incentive mode can be divided into two types: one is the incentive from owners to senior managers and the other is the incentive from senior manages to subordinate managers. If the company's main purpose is to encourage senior managers, it can choose the annual salary or the stock option incentive. If a company's main purpose is to encourage low-level managers, it can mainly use the position salary, bonus system, performance-linked incentive, gain sharing plan and spiritual incentive. In China, the stock option incentive plan includes restricted stocks and stock options. According to their own life cycle stages, companies should choose their own suitable incentive modes. So if the company is in the stage of growth, its cash is not sufficient or its operating risk is high, then it can select stock options; if the company is in the stage of maturity, its cash is more sufficient or it is in pursuit of success at low risks, then it can choose restricted stocks.

Shanghai Jahwa used the stock option incentive in order to mobilize the enthusiasm of senior managers and core technical staffs and also to prevent the loss of the talents. As Shanghai Jahwa was set up early and developed stably and had good prospects for development, it chooses the restricted stocks. But there is a high risk for restricted stocks, because it's very difficult for majority employees to join the incentive plan. According to the first phase of the exercise program, the incentive objects should spend at least RMB 270,000.00 to buy the directional issued shares for every year. In order to participate in the incentive plan, some employees borrowed from banks (or other financial institutions) and bear higher borrowing rates, which would have a bad influence to the staff's working life. So the company should choose the incentive mode carefully according to its funds and that of the incentive objects.

10.3.3 Choosing Incentive Objects Appropriately

In the aspect of the granted objects, and also listed corporations are in different industries, then their competitive environment will be different and their strategic targets and demands for talents are not the same. Therefore the tendency of different incentive objects and the degree of their corresponding incentive mechanisms are not the same. The company should choose the appropriate incentive objects according to its industry, scale, profitability and the purpose of incentive control system. If the company is in the high-tech industry where the core technical staffs plays an important role, then the range of incentive objects should focus on the core technical staffs. The company should increase the incentive strength for the core technical staffs so that it is conducive to achieve high growth. If the company is becoming larger and then it must coordinate the resources and relationship, it should make the interest of the core human capital more consistent with that of the company. So it should expand the range of incentive objects and allow the core staffs to be the incentive objects. If the company has good profitability, then it can expand the range of incentive objects. If the company's profitability is poor, it should narrow the range of the incentive objects and reduce the pressure caused by the incentive cost.

Shanghai Jahwa made the key middle-level managers and the core technical staffs be the incentive objects in order to attract and retain talents and granted them a higher proportion of shareholding, which improved the performance of the company as whole. However, the company's incentive range was excessively concentrated on middle management personnel and core technology backbone, while the senior management staffs only had a small proportion of shareholding and the general managers were not the incentive objects, which was not conducive to mobilize their enthusiasm. In Shanghai Jahwa, some people will work positively and the others will work less positively, which in generally speaking is not conducive for the long-term development of the company. Therefore, Shanghai Jahwa should appropriately expand the range of incentive objects within its own capacity.

10.3.4 Designing Evaluation Index and Evaluation Method Reasonably

Performance evaluation belongs to the evaluation control system and it is also an important part of the incentive control system. Reasonable performance evaluation system can make the incentive control system play a very big role of incentive. Therefore, the company should give full considerations to the advantages and disadvantages of each evaluation index and then design a set of comprehensive performance evaluation system that will fully reflect the management performance. The choice of the scientific performance evaluation index is not only refers to the evaluation of the operating performance, but also should include the evaluation of the incentive objects. In addition, the evaluation indexes of the operating performance

not only use financial indicators, but also should include the non-financial indicators. The company should comprehensively consider the advantages and disadvantages of various performance evaluation methods and then choose the appropriate evaluation method. In choosing of company evaluation method, it should consider the specific circumstances. The various evaluation methods are not mutually exclusive. For instance, EVA evaluation method can be combined with the traditional method to compensate for the lack of comparability and can also be combined with the balanced scorecard idea to analyze the future prospects for the development of companies. Therefore, according to the company's actual situation and the characteristics of the individual work position, the company should jointly use the various evaluation methods to evaluate the incentive objects.

In order to avoid the defects of a single evaluation index, that the first phase of the incentive plan used, Shanghai Jahwa adopted net profit and the weighted average rate of return on net assets as dual management performance evaluation indexes and achieved good results in the second phase. But these evaluation indexes are easily influenced by the accounting policy and management manipulation. They are lacking of consistency, ignoring the long-term interests and the future value of the company. To a large extent, financial evaluation indexes are limited to measure the past financial results of the activities. So the financial indexes should combine other non-financial indexes, such as management responsibility, development potential of company. The combination of qualitative indexes and quantitative indexes is helpful to improve the accuracy and consistency of performance evaluation indexes. At the same time, a company should avoid subjectivity rule while using the non financial evaluation indexes because they are difficult to quantify.

10.3.5 Improving Operating Environment of Incentive Control

The company survives in the environment as an organization, which requires its organizational structure to be compatible with both internal and external environment. The incentive control system must also match the external environment as a part of a company's organizational structure. Some companies had ignored the investigation on the operating environment of incentive control system, and these results into many difficulties and obstacles in practice. A good operating environment can not only avoid many negative effects but also can make the incentive control system play a persistent role of incentive.

However, when implementing the stock option incentive, the higher costs could not be amortized over a longer period because the second phase of the exercise period was set for a short time. At this time, Shanghai Jahwa should improve the operating environment of the evaluation system and the management information system of incentive control, formulate the stock option incentive plan reasonably, and forecast the problems that appears in the implementation of the process fully. In

addition, it should adjust the incentive plan and put forward the solution for the problems in the process of incentive control system operation timely so as to reduce the company's loss. Shanghai Jahwa should also continue to improve several other operation environment of incentive control system, such as, the evaluation control system, the financial management system, the strategic planning, the human resources management, the company culture, etc.